

MAYER | BROWN

IFLR



**A DEEP DIVE
INTO CAPITAL
RAISING
ALTERNATIVES**

About Mayer Brown

We are one of the leading securities and capital markets law firms in the world, advising issuers, underwriters and agents in domestic and international private and public financings. With offices in the world's major financial centers, our lawyers in each city know their local markets well and call upon fellow Mayer Brown professionals to deliver business-minded advice. Our practice is diverse, spanning the financing continuum—from private placements, to IPOs, to Rule 144A and Reg S offerings, to continuous issuance programs, like medium term note and commercial paper programs, to derivatives, structured products and structured finance and securitisation transactions. We have particular experience in certain industries, which include consumer and industrial products, energy, financial services, life sciences, specialty finance and technology. We are best known for our financial institutions work, and have longstanding relationships with many of the world's leading banks, insurance companies and specialty finance companies.

Mayer Brown's global team of IPO lawyers have experience guiding issuer and underwriter clients through the IPO process in most of the major markets across the globe, from the initial kickoff meeting through completion of the IPO. We also advise privately held companies and public companies, as well as placement agents, in connection with private placements of equity, equity-linked and debt securities. We count among our capital markets lawyers innovators in the private placement and PIPE market.

In addition, we regularly counsel companies, placement agents, private investors, and strategic investors in connection with mezzanine or late-stage private placements. We counsel our issuer and financial intermediary clients in these transactions, which often require addressing the rights of various series of existing stockholders. We also assist companies undertaking private tender offers to provide liquidity opportunities for early investors and employees, or to facilitate liquidity opportunities for these holders by bringing in new institutional and cross-over fund investors. Given the depth of our experience with private placements and IPOs, we are able to work effectively with our clients on these transactions while remaining focused on their strategic objectives and longer-term financing plans.

While we have exceptional credentials in many areas, we count as among our greatest strengths our global network, and our ability to marshal our resources and bring them to bear on complex cross-border transactions—joining together with a shared commitment to practical and timely advice.

Our blog, *Free Writings & Perspectives*, provides up-to-the-minute news regarding securities law developments, particularly related to capital formation, as well as commentary regarding developments affecting private placements, late stage private placements, PIPEs, IPOs and the IPO market, and new financial products. Visit www.freewritings.law/.

About the Authors

John R. Ablan

John is an associate in Mayer Brown's capital markets practice. John's practice focuses on representing underwriters and issuers in a wide variety of securities offerings, including public and private offerings of high yield and investment grade debt and equity, as well as tender and exchange offers. John is an experienced securities attorney. Prior to joining the firm he served as in-house counsel at a major investment bank in New York.

Contact: jablan@mayerbrown.com
+1 312 701 8018

F. Ryan Castillo

Ryan is counsel in Mayer Brown's capital markets practice. Ryan's work focuses on securities and corporate finance transactions. He advises issuers, investment banks and sponsors in connection with public offerings and private placements of debt, equity and hybrid securities, including initial public offerings, follow-on offerings, investment grade and high-yield debt offerings, private investment in public equity, tender and exchange offers, consent solicitations, medium term note programs and other capital markets transactions in the United States, Canada and the euro markets. He represents companies and financial intermediaries involved in a broad range of industries, including financial services, technology, telecommunications, retail, life sciences, real estate and energy.

Contact: rcastillo@mayerbrown.com
+1 212 506 2645

Carlos E. Juarez

Carlos manages the business and practice development for Mayer Brown's capital markets practice. He holds an MBA from the Leonard N. Stern School of Business at New York University, with concentrations in finance and accounting, and a BA from the University of California at Irvine.

Contact: cjuarez@mayerbrown.com
+1 212 506 2770

Anna T. Pinedo

Anna is a partner and co-leader of Mayer Brown's global capital markets practice. She concentrates her practice on securities and derivatives. Anna represents issuers, investment banks/financial intermediaries and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products. She works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products. She has particular financing experience in certain industries, including technology, telecommunications, healthcare, financial institutions, REITs and consumer finance. Anna has worked closely with foreign private issuers in their securities offerings in the United States and in the euro markets. She also works with financial institutions in connection with international offerings of equity and debt securities, equity- and credit-linked notes, and hybrid and structured products, as well as medium term note and other continuous offering programs.

Contact: apinedo@mayerbrown.com
+1 212 506 2275

Introduction

Many market participants were taken by surprise by the enactment of the Jumpstart Our Business Startups (JOBS) Act. The JOBS Act (also referred to as the Act), HR 3606, was passed by the United States House of Representatives on March 8 2012. On March 22, the Senate passed HR 3606 with an amendment to Title III (providing for the crowdfunding exemption with enhanced investor protections). On March 27, the House of Representatives accepted the Senate's amendment, and on April 5, President Obama signed the JOBS Act into law.¹ To many, this may sound like a quick path for legislation, especially when considered in the context of a Congress that seemed virtually deadlocked and unable to reach the consensus required to take action on pressing issues. When considered closely and in context, however, it becomes clear that the Act was the culmination of an at least year-long bipartisan effort in both the House and Senate to address concerns about capital formation and unduly burdensome Securities and Exchange Commission (SEC) regulations.

The JOBS Act affects both exempt and registered offerings, as well as the reporting

requirements for certain public issuers. The Act aims to ease regulatory burdens on smaller companies and facilitate capital formation by improving their access to the public capital markets. A centerpiece of the Act is an initial public offering (IPO) on-ramp approach for a class of companies, referred to as emerging growth companies, or EGCs, (Title I), with confidential SEC staff review of draft IPO registration statements, scaled disclosure requirements, no restrictions on test-the-waters communications with qualified institutional buyers (QIBs) and institutional accredited investors (IAs) before and after filing a registration statement, and fewer restrictions on research (including research by participating underwriters) around the time of an offering. In addition, the JOBS Act directs the SEC to amend its rules to:

- eliminate the ban on general solicitation and general advertising in Rule 506 offerings when sales are made only to accredited investors, along with comparable changes to Rule 144A (Title II);
- establish a small offering exemption for crowdfunding (Title III); and

- create a new exemption for offerings of up to \$50 million (Title IV).

The JOBS Act also raises the holder-of-record threshold for mandatory registration under the Securities Exchange Act of 1934, as amended (the Exchange Act) (Titles V and VI). In the chapters that follow, we discuss each of these measures in greater detail, but before we do so, it is important to understand the concerns that led legislators to act in concert to adopt the JOBS Act.

The lifecycle for emerging companies in the US

For a long time in the US, a company's financing lifecycle was generally fairly predictable. A growing company usually financed its business through investments from friends and family, then perhaps from angel investors, and finally, if the company was successful, from venture capital firms. Given the application of section 5 of the Securities Act of 1933, as amended (the Securities Act)² to public offerings of securities, a growing company was constrained to conducting small rounds of financing, relying on various available exemptions from the registration requirements of the Securities Act, and to target principally sophisticated institutional investors. The securities that a company sold in these private, or exempt, offerings were classified as restricted securities, which means that the securities had never been offered pursuant to a registration statement and were subject to certain transfer restrictions. After various successful private financing rounds, the company's management and venture investors would begin to consider an IPO. Once a company was an SEC reporting issuer, it became subject to a comprehensive regulatory framework under the federal securities laws. Although this regulatory framework may have imposed requirements that seemed onerous (at the time), being a public company offered distinct benefits. Once public, a company generally had many more financing opportunities. Already public companies could rely on raising additional capital

to finance their growth through follow-on public offerings, underwritten by one or more investment banks. From time to time, an already public company also might conduct a private placement or other exempt offering as part of an overall financing plan. Moreover, a successful IPO had been traditionally viewed as the crowning achievement for a growing company, and 'going public' signalled success and prestige, not only for the company's founders and management, but also for the venture capital and other institutional investors that backed the start-up early on.

Over time, as the capital markets in the US have undergone changes and as regulations have evolved, the cost-benefit calculus for many companies has indeed changed. Many companies have now concluded that going public might not be the most desirable liquidity event, and remaining private longer or considering acquisition alternatives might be more appealing. In a September 2019 speech, SEC Chairman Jay Clayton observed that: the US has roughly half the number of public companies it had twenty years ago; growing companies are staying private substantially longer; and IPOs are being used more for liquidity by venture capital and private equity investors than to access the capital markets.³ On another occasion, Chair Clayton noted that there has been a dramatic shift since the early 2000s from companies raising growth capital in the public equity markets to raising growth capital in the private capital markets.⁴ A bit of background on the securities regulatory framework will help illustrate why the cost-benefit analysis has changed for many companies.

Securities regulatory framework

A privately held company (or a company that does not have securities that are publicly traded in the US), whether domestic or foreign, that contemplates accessing the US markets, must first determine whether it is willing to subject itself to the ongoing securities reporting and disclosure requirements, as well as the corporate governance

requirements that are part and parcel of registering securities for a public offering in the US. An issuer may conduct a public offering in the US by registering the offer and sale of its securities pursuant to the Securities Act, and also by registering its securities for listing or trading on a US securities exchange pursuant to the Exchange Act.⁵ Instead of the public offering or listing route, an issuer may choose to access the US capital markets by offering its securities in an offering exempt from the registration requirements of the Securities Act. Finally, a private company that elects to postpone, or seeks to avoid, becoming a public company may become subject to SEC reporting obligations inadvertently if it has: total assets exceeding \$10 million as of the last day of its fiscal year, and a class of equity securities held of record by either 2,000 persons or 500 persons who are not accredited investors (for banks, savings and loan holding companies, and bank holding companies, a class of equity securities held of record by 2,000 or more persons), whether or not that class of equity securities is listed on a national securities exchange.

Section 5 of the Securities Act sets forth the registration and prospectus delivery requirements for securities offerings.⁶ In connection with any offer or sale of securities in interstate commerce or through the use of the mails, section 5 requires that a registration statement must be in effect and a prospectus meeting the prospectus requirements of section 10 of the Securities Act must be delivered before sale.⁷ This means that the Securities Act generally requires registration for any sale of securities, although it also provides exemptions or exclusions from this general registration requirement. The purpose of the Securities Act is to ensure that an issuer provides investors with all information material to an investment decision about the securities that it is offering. The registration and prospectus delivery requirements of section 5 require filings with the SEC and are intended to protect investors by providing them with sufficient information about the issuer and its business, operations and financial

condition, as well as about the offering, so that they may make informed investment decisions. These apply to offerings that are made to the general public (regardless of the sophistication of the offerees). The SEC presumes that distributions not involving public offerings (or widespread distributions) do not raise the same public policy concerns as offerings made to a limited number of offerees that have access to the same kind of information that would be included in a registration statement. That information can be conveyed by providing disclosure or by ensuring that the offerees have access to the information. There are a number of regulatory restrictions on communications for issuers that undertake a public offering, given that the SEC has always emphasized that the prospectus should be the principal document used by investors in making their investment decisions.

IPO and Exchange Act registration

In connection with an IPO of securities, an issuer must provide extensive information about its business and financial results. The preparation of the registration statement is time-consuming and expensive. Once the document is filed with the SEC, the SEC staff will review it closely and provide the issuer with detailed comments. The comment process may take as long as 60 to 90 days once a document has been filed with, or submitted to, the SEC. Once all of the comments have been addressed and the SEC staff is satisfied that the registration statement is properly responsive, the registration statement may be used in connection with the solicitation of offers to purchase the issuer's securities. Depending upon the nature of the issuer and the nature of the securities being offered by the issuer, the issuer may use one of various forms of registration statements. Once an issuer has determined it will register its securities under the Securities Act, the issuer usually will also apply to have that class of its securities listed or quoted on a securities

exchange, and in connection with doing so, will register its securities under the Exchange Act. The Exchange Act imposes two separate but related obligations on issuers: registration obligations and reporting obligations. If an issuer becomes subject to the reporting requirements of the Exchange Act, the issuer remains subject to those requirements until, in the case of exchange-listed securities, those securities are delisted, or, in the case of securities listed by reason of the issuer's asset size and number of record holders, the issuer certifies that it meets certain requirements.

Once an issuer conducts an IPO in the US or has a class of securities listed or traded on a national securities exchange, the issuer will be generally subject to the reporting requirements of the Exchange Act. Issuers that have undertaken an IPO or that are SEC-reporting companies will also become subject to many other rules and regulations.

Over time, the regulatory burdens for public companies have increased. In 2002, following a series of widely reported corporate scandals involving fraudulent accounting practices and governance abuses, the US adopted legislation affecting all public companies, the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).⁸ It imposed a broad series of requirements relating to corporate governance, enhanced public disclosure, and the imposition of civil and criminal penalties for wrongdoing. Sarbanes-Oxley and its associated rules:

- require that chief executive officers (CEOs) and chief financial officers (CFOs) certify the accuracy and completeness of their companies' periodic reports and impose criminal penalties for false certification;
- require the establishment and regular evaluation of disclosure controls and procedures, and internal control over financial reporting (ICFR) designed to ensure the accuracy and completeness of the information reported to the SEC and for the preparation of financial statements;
- require the establishment by all listed companies of an independent audit committee;
- require the disgorgement of compensation by

CEOs and CFOs following an accounting misstatement that results from misconduct;

- impose limitations on trading by officers and directors during retirement plan blackout periods;
- prohibit the extension of credit to related parties; and
- require the SEC to review a registrant's filings once every three years.

Although relief from compliance with some of these requirements was provided to smaller companies and certain foreign private issuers (FPIs), increased compliance costs and increased liability may have had a chilling effect on IPOs.

To go or not to go public

Many commentators have noted that, over time, the US capital markets have become less competitive and the number of companies seeking to go public has declined. For example, prior to the enactment of the JOBS Act, in communications from Congressman Darrell Issa, Chairman of the House Committee on Oversight and Government Reform, to Mary Schapiro, Chairman of the SEC (discussed further below), Issa noted that the number of IPOs in the US plummeted from an annual average of 530 during the 1990s to about 126 since 2001, with only 38 in 2008 and 61 in 2009.⁹ The number of companies listed on the main US exchanges peaked at more than 7,000 in 1997 and, as of the date of the letter, had been declining to about 4,000.¹⁰ Meanwhile, the value of transactions in private company shares had grown, almost doubling in 2010 to \$4.6 billion from about \$2.4 billion in 2009, and was expected to increase to \$6.9 billion for 2011.¹¹ Other reports published during the same time period cited similar statistics and highlighted that smaller companies were disproportionately affected, with most IPOs that completed involving larger companies and a significant offering size. Although commentators would have been ready to stipulate that the number of IPOs had declined, there would be

little agreement regarding the causes for the decline. Quite a number of different theories have been advanced to explain this phenomenon. Academics active in this area have grouped the theories into two broad categories: first, those attributing the decline to regulatory overreach; and second, those attributing the decline to changes in the ecosystem or market structure changes.

Many studies indicate that companies are waiting longer to go public as a result of anticipated costs associated with Sarbanes-Oxley compliance, as well as the additional costs associated with being a public company. For example, a public company must incur costs for directors' and officers' insurance, director compensation (especially audit committees), and disclosure controls and SEC reporting costs. Foreign issuers may be wary of the increased liability that comes with being an SEC-reporting company, as well as of the litigious environment in the US. Many executive officers of privately held companies are also concerned that going public will limit their flexibility. As officers of a public company, they are required to make very difficult decisions, including decisions regarding financial reporting, accounting estimates, and accounting policies, while they are subject to more scrutiny and more risk as a result of their choices. Given the prospect of shareholder litigation and other litigation concerns, their determinations become fraught with risk. Earnings pressure and the need to respond to many constituencies (such as research analysts, large institutional holders, aggressive hedge fund holders and other activist investors) may affect the decision-making processes. This may inhibit their desire to take risk and may lead them to be more conservative than they otherwise would be. A survey found that, in fact, the principal reason given by senior managers of privately held companies for remaining private is that they would like to preserve decision-making control.¹² In addition, actually conducting an IPO will be time-consuming and expensive given the disclosure and financial statement requirements.

Over time, more financing alternatives have developed for issuers, especially in the private capital markets. An issuer could choose to avail itself of one of the exemptions from registration and conduct private offerings. There have been many regulatory changes that have provided greater legal certainty as to the availability of private offering exemptions, such as the safe harbors contained in Regulation D, especially Rule 506. In large measure, as a result of these changes, a number of securities offering methodologies involving exempt offerings have developed and become increasingly popular. Many of these offering methodologies have come to resemble the process used for public distributions of securities. Investors have become more receptive to participating in private placements and owning so-called restricted securities as the limitations on hedging or transferring restricted securities have been relaxed. Different types of investors are willing and eager to participate in private placements undertaken by promising companies. These now include, in addition to venture capital funds, private equity funds, family offices, sovereign wealth funds, insurance companies, pension funds, and crossover funds. More recently, private secondary markets have developed that provide liquidity opportunities for holders of the securities of private companies to sell their positions.

Other commentators and academics note that a variety of market structure changes may be the cause of or may contribute to the decline of IPOs, especially smaller company IPOs. During the 1990s and early 2000s, consolidation in the investment banking sector led to the disappearance of many boutique or speciality investment banks that had as their focus financing transactions for smaller companies. Some commentators point to the drop in bid-ask spreads that took place following decimalisation in 2001. In 2003, as a result of the fallout from the dotcom boom, rules and regulations were adopted that imposed restrictions on research analyst coverage and required the separation of research and investment banking activities. The

burdensome regulations imposed significant compliance costs on investment banks with research activities and changed the nature of research coverage. As a result, the fewer, larger investment banks that remained after industry consolidation focused their resources on covering fewer companies (usually giving preference to larger, well-capitalized companies). These various factors seemed to change the economics associated with smaller company IPOs, and tend to favour IPOs by larger, more established companies – as well as the view developed that larger companies, with a longer track record and more predictable earnings histories, make better public companies or are better able to function as public companies.

SEC developments

The SEC has tried to keep pace with changes in the capital markets and has consistently introduced reforms seeking to balance investor protection needs with the need to provide issuers with access to capital. Since the early 1980s, the SEC has undertaken a number of steps to facilitate capital formation. The SEC has, among other changes, created and modified the integrated disclosure system, instituted and expanded the continuous and delayed offerings processes, permitted the electronic submission of most SEC filings, and generally tried to accommodate the needs of both large and small issuers. In 2005, the SEC undertook a series of changes related to securities offerings and offering-related communications, referred to as securities offering reform. Although this reform principally benefited the largest and most sophisticated issuers (well-known seasoned issuers or WKSIs), the changes also expanded the range of permissible communications, even during IPOs.

In December 2004, the SEC established the Advisory Committee on Smaller Public Companies (the Advisory Committee) to ‘assist the SEC in evaluating the current securities

regulatory system relating to disclosure, financial reporting, internal controls, and offering exemptions for smaller public companies’.¹³ The Advisory Committee charter stated that its objective was ‘to assess the impact of the current regulatory system for smaller companies under the securities laws of the United States and to make recommendations for changes’.¹⁴ The Advisory Committee considered the effect of many new regulatory requirements on smaller public companies, as well as capital-raising alternatives for smaller companies. In 2006, it issued its final report, containing 33 recommendations, many of which focused on capital formation, including a recommendation that a new private offering exemption from the Securities Act registration requirements be adopted that would not prohibit general solicitation and advertising for transactions with purchasers that do not need all the protections of Securities Act registration requirements. The Advisory Committee noted that the ban on general solicitation in a private offering resulted in excessive concern about the offeree – who may never actually purchase securities – rather than on protection of the actual investors. The Advisory Committee also noted that, given the pace of technological change, the ban had become outmoded and limited issuers from using the internet and other tools to communicate with potential investors. This was not the first time that a recommendation had been made to ease the prohibition on general solicitation. In 2007, practitioners that were members of an American Bar Association committee submitted a letter to the SEC containing recommendations for a comprehensive overhaul of the securities laws governing the private placement of securities.¹⁵ The letter cited problems with the private offering process that impacted capital formation. In May 2007, the SEC approved the publication of eight releases designed to update and improve federal securities regulations that significantly affect smaller public companies and their investors. Ultimately, the holding period requirements under Rules 144 and 145 were shortened, making

restricted securities more liquid, and smaller public companies gained limited access to the use of shelf registration statements.

Although all of these reforms modernized the securities offering process, streamlined communications requirements, and addressed certain of the concerns related to private or exempt offerings, the reforms during this period did not squarely address the IPO process, nor did they address many of the thorniest issues arising in exempt offerings.

Proposed changes post-Dodd-Frank Act

In the aftermath of the financial crisis, and following adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act¹⁷ (generally known simply as the Dodd-Frank Act) in 2010, there was renewed focus on the effect of regulation on the competitiveness of the US capital markets and on entrepreneurship and emerging companies. As attention in the US turned to promoting economic activity, the dialogue related to regulatory burdens and their effect on capital formation took on a new sense of urgency.

Issa-Schapiro correspondence

On March 22 2011, House Committee on Oversight and Government Reform Chairman Issa sent a letter to SEC Chairman Schapiro. The letter raised concerns about whether the current securities regulatory framework had a negative impact on capital formation, leading to the dearth of IPOs in the US, as well as the extent to which SEC regulations potentially limited other capital-raising activities by small and emerging companies.¹⁶ The letter from Issa also sought specific information regarding economic studies conducted by the SEC staff in these areas, along with information concerning the consideration of costs and benefits in connection with SEC

rulemakings. Issa's letter discussed these statistics and raised questions about five topics: the decline of the US IPO market, the communications rules in connection with securities offerings, the 499 shareholder cap under section 12(g) of the Exchange Act, organizational considerations, and new capital-raising strategies.

In her response dated April 6 2011, Schapiro stated she had requested that the SEC staff take a fresh look at the agency's rules in order to develop ways for the SEC to reduce the regulatory burden on small business capital formation in a manner consistent with investor protection.¹⁸ Schapiro outlined a number of new SEC initiatives in her response, including SEC staff review of (i) the restrictions on communications in IPOs; (ii) whether the general solicitation ban should be revisited; (iii) the number of shareholders that trigger public reporting, including questions regarding the use of special purpose vehicles (SPVs); and (iv) the regulatory questions posed by new capital-raising strategies, such as crowdfunding. Schapiro also indicated that the SEC was in the process of forming a new Advisory Committee on Small and Emerging Companies, which was subsequently convened.

Decline of the IPO market in the US

Issa's letter cited statistics about the declining US IPO market and asked whether the SEC had evaluated the reasons for such a decline. The letter asked whether the possible reasons for the decline included increasingly complex SEC regulations; costs associated with compliance with Sarbanes-Oxley; the uncertainty generated by the pending rulemakings under the Dodd-Frank Act; the risk of class-action lawsuits; or the expansion of regulatory, legal, and compliance burdens. The letter also cited examples of the IPOs of Google and GoDaddy.com that were delayed and canceled, respectively, as evidence of overly burdensome communications rules. In her response, Schapiro discussed various reasons for the decline in the IPO market, such as each

company's own situation and market factors at the time of the contemplated IPO. Schapiro stated that it is difficult to determine why a company decides to undertake an IPO or declines to do so. The costs associated with conducting an IPO and becoming a public reporting company factor into the decision as to whether to conduct an IPO. Schapiro stated that the SEC had lowered these costs in recent years and that, in 2010, approximately 40% of first-time registrants were smaller reporting companies. Similarly, in 2010, nearly half of registered offerings conducted by first-time registrants were for offerings of less than \$10 million. In a discussion about the challenges faced by early-stage growth companies, Schapiro pointed out that such companies have greater difficulty raising capital because of the lack of disclosure on a regular basis, smaller and more variable cash flows, a smaller asset base, and a larger percentage of intangible assets.

Schapiro also stated that while there are studies that show that the number of US IPOs had declined,¹⁹ other studies conducted by SEC staff members indicate that for the period 1995–2007, the US market's share of global IPOs in terms of total dollar proceeds and average dollar proceeds was much higher than those of the UK and Hong Kong.²⁰ The other reason for companies to favour an IPO in the European markets is that the underwriters' spread is significantly lower than in the US. For example, the gross spread in the US for an offering size between \$25 million and \$100 million is approximately 7%, while in Europe it would be approximately 45 for a similar offering.

The impact of the communications rules

In his letter, Issa indicated that the communication rules governing the offerings of securities potentially conflict with the promotion of disclosure and transparency and the First Amendment. He requested an explanation for the potential harm to a non-accredited investor that

may realistically result from the receipt of an advertisement by an issuer of unregistered securities that is targeted at accredited investors. In her response, Schapiro described the communications rules that apply to registered and unregistered offerings. Under the Securities Act, for registered offerings, an issuer's ability to communicate varies depending on the three phases of the registration process called the pre-filing period, quiet period, and the post-effective period.²¹ During the pre-filing period before filing a registration statement, an issuer may not offer securities.²² During the quiet period (or waiting period), an issuer can make oral offers but cannot make written offers other than through a prospectus that complies with section 10 of the Securities Act.²³ In the post-effective period, an issuer can sell and deliver securities as long as a final prospectus that complies with section 10(a) of the Securities Act accompanies or precedes delivery of the securities.

Schapiro discussed the offering reforms adopted in 2005 that liberalized an issuer's ability to communicate during offerings.²⁴ She also clarified that had these rules been effective when Google and Salesforce.com conducted their IPOs, the SEC would not have imposed a cooling-off period to address gun-jumping concerns. Schapiro's letter points out that with respect to offerings not registered under the Securities Act, issuers relying on section 4(a)(2) of the Securities Act or its safe harbor, Rule 506 of Regulation D, generally are not allowed to use a general solicitation or advertising to attract investors to their offering. In addition, the SEC adopted Rule 155, another safe harbor, that allows companies to abandon a public offering and instead raise money through a private offering. Schapiro recognised that some view the general solicitation ban as a significant burden on capital-raising and may be unnecessary, as offerees who might be located through general solicitation and who might not purchase the securities would not be harmed.²⁵ Others, however, supported the solicitation ban on the grounds that it helps prevent securities fraud by making it more

difficult for fraudsters to attract investors or unscrupulous issuers to condition the market.²⁶

The 499 shareholder cap

Issa raised concerns about the 499 shareholder cap under section 12(g) of the Exchange Act as being a fundamental roadblock to private equity capital formation. The letter went on to cite the case of the Facebook equity issuance in which the 499-person threshold would have been overcome by grouping multiple shareholders into single entities. He questioned whether the use of SPVs for the purposes of facilitating investments in private companies resulted in disjointed or illiquid markets and prevented price discovery.

In her letter, Schapiro stated that Rule 12(g) of the Exchange Act was enacted by Congress in 1964 and that the securities markets have changed significantly since then. The section requires a company to register its securities with the SEC within 120 days after the last day of its fiscal year if, at the end of the fiscal year, the securities are held of record by 500 or more persons and the company has total assets exceeding \$10 million. Schapiro pointed out that today, the vast majority of shares of public companies are held in nominee or so-called street name and, as a result, individual shareholders are not counted because the securities are not held of record by those individuals. Conversely, in private companies, shareholders generally hold their shares directly, or of record, and thus those companies may exceed the 499-shareholder limit under Rule 12(g), which would require them to commence reporting. Schapiro stated in her letter that the issue of how holders are counted and how many holders should trigger registration will need to be examined.

In his letter, Issa also raised concerns about Rule 12g5-1(b)(3) of the Exchange Act. That rule states that if an issuer knows that the form of holding securities of record is primarily used to circumvent section 12(g), the beneficial holders will be deemed the record owners. Noting that this rule has been invoked sparingly, Schapiro stated that it is not

meant to create uncertainty for issuers, but rather is intended to prevent issuers from circumventing the registration requirements.

Schapiro also noted that Congress has provided the SEC with broad authority, in sections 12(h) and 36 of the Exchange Act, to make exemptions with respect to the section 12(g) registration requirements, and that section 12(g) of the Exchange Act also allows the SEC to define the terms held of record and total assets. Therefore, the SEC has the requisite authority to revise the shareholder threshold if it concludes that doing so is not inconsistent with the public interest or protection of investors.

Crowdfunding as a new capital-raising strategy

The letter from Issa raised questions regarding crowdfunding, singling out that approach as a possible new method of capital formation that has gained popularity. Schapiro stated that she understands crowdfunding to be a new method of capital formation whereby groups of people pool money, typically small individual contributions, to support an effort by others to accomplish a specific goal. Initially, such arrangements did not trigger securities law issues because there was no profit participation. Schapiro noted, however, that interest in offering an ownership interest in a developing business and an opportunity for a return on investment capital is growing. She noted that proponents of this approach to capital formation seek a registration exemption, and the SEC has been exploring several approaches to address this.²⁷

Legislative and other efforts

At more or less the same time that these exchanges were taking place, legislative efforts were moving forward that contemplated other changes to the capital formation process for smaller and emerging companies. Representative David

INTRODUCTION

Schweikert introduced the Small Company Capital Formation Act of 2011 in the US House of Representatives, which sought to amend the Regulation A offering threshold from \$5 million to \$50 million for public offerings by smaller companies.²⁸ The Small Company Formation Act was introduced after hearings on the topic of capital formation were held in December 2010, during which industry representatives expressed support for Regulation A reform, as well as other changes to the capital formation process.

During the same session of Congress, other individual bills were introduced that would have increased the threshold for mandatory registration for all companies under the Exchange Act from 500 persons holding equity securities of record to 1,000 persons, and that would have amended section 12(g) of the Exchange Act by raising the registration threshold from 500 to 2,000 record holders if the issuer is a bank or a bank holding company.²⁹ Representative Patrick McHenry introduced legislation that would have added a crowdfunding exemption under both section 4 of the Securities Act and section 12(g) of the Exchange Act. Representative Kevin McCarthy introduced legislation to amend section 4(a)(2) of the Securities Act to state specifically that general solicitation and general advertising would not affect the availability of the private placement exemption to registration under section 5 of the Securities Act, and to direct the SEC to remove the prohibition against general solicitation and advertising for securities issued under Rule 506 of Regulation D, provided that all purchasers of the securities are accredited investors and that the issuer took reasonable steps set forth by the SEC to ascertain that the holder is indeed an accredited investor. Of course, these individual legislative proposals were the precursors to the JOBS Act.

In March 2011, the US Treasury Department convened the Access to Capital Conference to ‘gather insights from capital markets participants and solicit recommendations for how to restore access to capital for emerging companies – especially public capital through the IPO market’. At this conference, a small group of professionals

representing broad sectors of the IPO market decided to form the IPO Task Force to examine the challenges that EGCs face in pursuing IPOs, and to provide recommendations for restoring effective access to the public markets for EGCs.

The IPO Task Force published its report, titled *Rebuilding the IPO On-Ramp*, in October 2011.³⁰ In the report, the IPO Task Force noted that after achieving a one-year high of 791 IPOs in 1996, the US IPO market severely declined from 2001 to 2008, averaging only 157 IPOs per year during that period, with a low of 45 in 2008, with IPOs by smaller companies showing the steepest declines. The report presents a nuanced view of the causes of this decline, pointing to a series of regulatory and market structure changes. The report notes that these changes have coalesced and, as a result, have had the effect of driving up costs for smaller companies looking to go public; constraining the amount of information available to investors about such companies; and shifting the economics of investment banking away from long-term investing in such companies and toward high-frequency trading of large-cap stocks, thus making the IPO process less attractive to, and more difficult for, smaller companies. The report made four principal recommendations to the Treasury Department: providing an on-ramp (or phasing in of disclosure requirements) for smaller companies that complete IPOs; improving the availability and flow of information for investors before and after an IPO; lowering the capital gains tax rate for investors who purchase shares in an IPO and hold these shares for a minimum of two years; and educating issuers about how to succeed in the new capital markets environment. The IPO Task Force stressed that these recommendations purport only to adjust the scale of current regulations; not to change the focus on investor protection.

In December 2011, legislation, titled the *Reopening American Capital Markets to Emerging Growth Companies Act of 2011*, was introduced that incorporated many of the recommendations included in the IPO Task Force report, including a proposal to amend section 2(a)

of the Securities Act and section 3(a) of the Exchange Act by creating a new category of issuer called an EGC and exempting these emerging EGCs, at least initially, from certain requirements. This legislation formed the basis of much of Title I of the JOBS Act.

The legislative efforts received a boost when, in January 2012, President Obama expressed support for a number of these initiatives. During his State of the Union address, the President emphasized the need to foster innovation and encourage start-ups and small businesses. On January 31 2012, the President released the Startup America Legislative Agenda to Congress, which reflected support for an increase in the offering threshold in Regulation A, a 'national framework' for crowdfunding, and the adoption of an IPO on-ramp. Shortly thereafter, the individual legislative initiatives referenced above coalesced into a single legislative proposal.

The JOBS Act and the IPO market

In the years following enactment of the JOBS Act, the IPO market in the US has improved. Market participants attribute the health of the US IPO market largely to overall improved economic conditions. Growing US companies continue to debate whether to pursue an IPO or to defer an IPO and rely on private placements to raise capital. In part, the ability to submit an IPO registration statement confidentially and the ability to test-the-waters with certain institutional investors has made it easier for many prospective IPO issuers to explore the IPO alternative. According to published statistics, 2014 was the best year since 2000 for the number of US IPOs and the gross proceeds raised through IPOs. In 2014, there were 297 IPOs, which raised \$85.6 billion. However, 2015 and 2016 were marked by volatility and many companies chose to delay their IPOs. In 2015, 170 IPOs were completed, accounting for approximately \$30 billion in aggregate gross proceeds. In 2016, 117 IPOs were

completed, accounting for approximately \$21.9 billion in aggregate gross proceeds. In 2017, 189 IPOs were completed, accounting for approximately \$44 billion in aggregate gross proceeds. In 2018, 234 IPOs were completed, accounting for approximately \$56.3 billion in aggregate gross proceeds. In 2019, 165 IPOs were completed, accounting for approximately \$50.0 billion in aggregate gross proceeds.

During the past five years, we have borne witness to the phenomenon of unicorns, or privately held companies with a market value of at least \$1 billion. Many successful private companies have found that they can raise substantial amounts in private placements completed at attractive valuations made to large institutional investors, often including the same types of institutions that historically would have invested principally or exclusively in IPOs or in publicly held companies. The SEC has also observed that the amount raised by companies in the US private capital markets for the period covering 2009 to 2018 is significantly higher than the amounts raised in the US public capital markets during the same period. The SEC's Division of Economic Risk and Analysis also reported that in 2018, registered offerings accounted for an estimated \$1.4 trillion of new capital, compared to approximately \$2.9 trillion raised through exempt offerings.³¹

While it is difficult to attribute the number of IPOs directly to the JOBS Act, market participants and legislators were encouraged by IPO activity in the early years following the Act's adoption. SEC Chairman Clayton also opined that the JOBS Act has been instrumental in slowing down the shift from companies raising growth capital in the public markets to the private markets.³² Also, the continued decline in the number of US public companies has led many legislators to advocate extending various provisions of the JOBS Act to a broader array of companies, as well as to undertake other initiatives designed to promote capital formation. Some of these proposals were recommended by the SEC's Advisory Committee on Smaller Public

Companies or by other small business groups. A number of enhancements to the JOBS Act and other securities law-related measures found their way into a highway and transportation infrastructure bill as riders. This legislation, which is titled the Fixing America's Surface Transaction Act (the FAST Act), was enacted on December 4 2015.³³ Over the past two years, the SEC has also embarked on a number of initiatives aimed at facilitating capital formation in the public markets and encouraging companies to enter the public markets earlier. For instance, in June 2017, the SEC announced that the Division of Corporation Finance will permit all issuers, not just EGCs, to submit draft registration statements relating to IPOs for review on a non-public basis, in effect expanding a popular feature of the JOBS Act.³⁴ In September 2019, the SEC also expanded the test-the-waters accommodation granted to EGCs in the JOBS Act to all issuers, allowing them to gauge investor interest in a potential offering prior to a registration statement filing.³⁵ In March 2020, the SEC also proposed amendments to harmonize, simplify, and improve the exempt offering framework in order to promote capital formation and assist companies in accessing growth capital from the private markets, and ultimately guide their path towards an IPO.³⁶ The US Congress and the SEC continue to evaluate additional measures that may spur IPO activity.

In the chapters that follow, we provide a summary of the main provisions of the JOBS Act and a discussion of their effect on capital formation.

Endnotes

- 1 Jumpstart Our Business Startups Act, Pub. L. No. 112-106.
- 2 Securities Act of 1933, 48 Stat. 74 (May 27 1933), codified at 15 USC section 77a *et seq.*
- 3 See Jay Clayton, SEC Chairman, *Remarks to the Economic Club of New York*, (Sep 9 2019), available at www.sec.gov/news/speech/speech-clayton-2019-09-09.
- 4 See Jay Clayton, SEC Chairman, *Testimony on "Oversight of the Securities and Exchange Commission" before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, (Dec 10 2019), available at www.sec.gov/news/testimony/testimony-clayton-2019-12-10.
- 5 Securities Exchange Act of 1934, 48 Stat. 881 (Jun 6 1934), codified at 15 USC section 78a *et seq.*
- 6 15 USC section 77e.
- 7 15 USC section 77e(b).
- 8 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in various sections of 15 U.S.C. and 18 U.S.C.), section 301, 302, 404, 406, 407 and 906.
- 9 See www.lexissecuritiesmosaic.com/resourcecenter/Issa.041211.pdf.
- 10 See *id.*
- 11 See Jean Eaglesham, *U.S. Eyes New Stock Rules*, *The Wall Street Journal* (Apr 8 2011), available at www.wsj.com/articles/SB10001424052748704630004576249182275134552.
- 12 See James C. Brau & Stanley E. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, 61 J. FIN. 399 (2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=530924.
- 13 Securities Act Release No. 33-8514, 87 S.E.C. Docket 1138 (Feb 28 2006); Exchange Act Release No. 34-50864, 84 S.E.C. Docket 1340 (Dec 16 2004).
- 14 Advisory Committee on Smaller Public Companies, Charter, available at www.sec.gov/info/smallbus/acspc.shtml.
- 15 Letter from Keith F. Higgins, Chair, American Bar Association Committee on Federal Regulation of Securities, to John W. White, Director, Division of Corporation Finance (Mar 22 2007), available at <https://www.sec.gov/comments/s7-11-07/s71107-4.pdf>
- 16 See www.knowledgemosaic.com/resourcecenter/Issa.041211.pdf.
- 17 Dodd-Frank Wall Street Reform and Consumer Protection Act (codified at section 12 U.S.C. section 5301 *et seq.*).
- 18 See www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.
- 19 See, e.g., D. Weild and E. Kim, *A Wake Up Call for America*, Grant Thornton LLP (2009); Committee on Capital Markets Regulation, *Continued Erosion in Competitiveness of the U.S. Equity Markets* (2009).
- 20 See C. Caglio, K. Weiss Hanley and Marietta-Westberg, *Going Public Abroad: The Role of International Markets for IPOs* (Feb 2011).
- 21 The Securities Act does not state when the pre-filing period begins. The SEC has stated that an issuer will be in registration at least from the time it begins preparing the related registration statement or the time it has reached an understanding with an underwriter, even if all the terms or conditions of the underwriting arrangement have not been agreed upon. See Release No. 33-5009, *Publication of Information Before or After the Filing and Effective Date of a Registration Statement Under the Securities Act of 1933* (Oct 7 1969); Release No. 33-5180, *Guidelines for Release of Information by Issuers Whose Securities Are in Registration* (Aug 16 1971).
- 22 See Securities Act section 5(c).

INTRODUCTION

- 23 See Securities Act section 5(b)(1).
- 24 See Release No. 33-8591, Securities Offering Reform (Jul 19 2005), available at www.sec.gov/rules/final/33-8591.pdf.
- 25 See, e.g., Final Report of the Advisory Committee on Smaller Public Companies to the SEC (Apr 23 2006), www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf; Joseph McLaughlin, *How the SEC Stifles Investment – and Speech*, *The Wall Street Journal* (Feb 3 2011). Concerns about the scope of the SEC’s rules on general solicitation and advertising have been raised by the participants in the annual SEC Government-Business Forum on Small Business Capital Formation. See 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report (May 2010), available at www.sec.gov/info/smallbus/gbfor28.pdf.
- 26 See *Pinter v Dahl*, 486 U.S. 622, 644 (1988) (“The purchase requirement clearly confines section #1 liability to those situations in which a sale has taken place. Thus, a prospective buyer has no recourse against a person who touts unregistered securities to him if he does not purchase the securities.”)
- 27 For example, crowdfunding was discussed at the SEC’s Nov 2010 Forum on Small Business Capital Formation. Participants in the Forum recommended that the SEC consider implementing a new exemption from Securities Act registration for crowdfunding, which would include offerings of up to \$100,000 and a cap on individual investments not to exceed \$100. In January 2011, representatives from the Division of Corporation Finance’s Office of Small Business Policy met with a group from the Small Business & Entrepreneurship Council, which advocated an exemption from registration requirements for crowdfunding offerings meeting specific requirements. In addition, the Office of Small Business Policy and other members of the Division of Corporation Finance staff discussed crowdfunding with representatives from the North American Securities Administrators Association, the organization of state securities regulators, at a conference held on Mar 28 2011.
- 28 HR 1070, available at www.gpo.gov/fdsys/pkg/BILLS-112hr1070ih/pdf/BILLS-112hr1070ih.pdf.
- 29 Note that this change merely puts into the statute the current requirements of SEC rules under sections 12(g) and 15(d).
- 30 Available at www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.
- 31 See Release No. 33-10649, Concept Release on Harmonization of Securities Offering Exemptions, (Jun 18 2019), at 16, available at www.sec.gov/rules/concept/2019/33-10649.pdf.
- 32 See SEC Chairman Testimony, supra note 4.
- 33 FAST Act (Pub. L. No. 114-94).
- 34 See SEC Press Release, *SEC’s Division of Corporation Finance Expands Popular JOBS Act Benefit to All Companies* (Jun 29 2017), available at <https://www.sec.gov/news/press-release/2017-121>; see also SEC Announcement, *Draft Registration Statement Processing Procedures Explained* (Jun 29 2017), available at <https://www.sec.gov/corpfin/announcement/draft-registration-statement-processing-procedures-expanded>.
- 35 See Release No. 33-10699, Solicitations of Interest Prior to a Registered Public Offering (Sep 26 2019), available at www.sec.gov/rules/final/2019/33-10699.pdf.
- 36 See Release No. 33-10763, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, (Mar 4 2020), available at www.sec.gov/rules/proposed/2020/33-10763.pdf.

CHAPTER 1

The IPO on-ramp

Title I of the JOBS Act establishes a new process and disclosure regime for IPOs by a new class of companies referred to as EGCs. As discussed in the introduction, Title I of the JOBS Act was enacted based on the recommendations of the Task Force, which sought ways to improve the offering process to encourage more IPO activity in the United States. As the true centerpiece of the JOBS Act, Title I contemplates, for those companies that qualify as EGCs, confidential SEC staff review of draft IPO registration statements, scaled disclosure requirements, no restrictions on test-the-waters communications with QIBs and IAIs before and after filing a registration statement, and fewer restrictions on research (including research by participating underwriters) around the time of an offering. Because Title I was retroactively effective to December 9 2011 for issuers that qualified as EGCs, it has had the most significant impact to date on the regulation of capital formation transactions. The changes brought about by Title I have been viewed as a success and, as discussed in further detail below, in the years following the adoption of the JOBS Act, the SEC has, through its rulemaking power, extended many of the benefits afforded to EGCs to all issuers.

Given the immediate effectiveness of Title I of the JOBS Act, the SEC staff provided interpretive guidance in the form of frequently asked questions (FAQs) posted on the SEC's website. The FAQs were initially issued on April 16 2012 and were updated on May 3 2012, September 28 2012 and December 21 2015.¹ These FAQs are not rules

or regulations of the SEC, but rather reflect the views of the staff of the SEC's Division of Corporation Finance.

The definition of EGC

In order to qualify for the IPO on-ramp contemplated by Title I of the JOBS Act, an issuer must be an EGC, which is determined for purposes of the reporting, accounting, auditing and corporate governance breaks that the company may use if it went public through a registered securities offering on or after December 9 2011, and for an IPO at any time during the process when the EGC is making use of the Title I provisions.

The revenue test

An EGC is defined for purposes of Title I as an issuer (including an FPI) with total annual gross revenues of less than \$1.07 billion (originally \$1 billion, but amended for inflationary adjustments) during its most recently completed fiscal year.² The SEC indicates that the phrase 'total annual gross revenues' means total revenues of the issuer (or a predecessor of the issuer, if the predecessor's financial statements are presented in the registration statement for the most recent fiscal year), as presented on the income statement in accordance with US generally accepted accounting principles (GAAP).³ If an FPI is using International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) as its basis for presentation, then the IFRS revenue number is used for this test.⁴ Because an issuer must determine its EGC status based on revenues as expressed in US dollars, the SEC staff indicates that an FPI conversion of revenues should be based on the exchange rate as of the last day of the fiscal year.⁵ For financial institutions, the SEC has indicated that total annual gross revenues should be determined in the manner consistent with the approach used for determining status as

a 'smaller reporting company', which looks to all gross revenues from traditional banking activities. For this purpose, a financial institution must include all gross revenues from traditional banking activities. Banking activity revenues include interest on loans and investments, dividends on investments, fees from loan origination, fees from trust and investment services, commissions, brokerage fees, mortgage servicing revenues, and any other fees or income from banking or related services. Revenues do not include gains and losses on dispositions of investment portfolio securities (although it may include gains on trading account activity if that is a regular part of the institution's activities).⁶

By way of example, the SEC indicates that, in applying the revenue test for determining EGC status, a calendar year-end issuer that would like to file a registration statement for an IPO of common equity securities in January 2013 (which would present financial statements for 2011 and 2010 and the nine months ended September 30 2012 and 2011) should look to its most recently completed fiscal year, which would be the most recent annual period completed, regardless of whether financial statements for the period are presented in the registration statement. In this example, the most recent annual period completed would be 2012.⁷

Applicability of the December 9 2011 effective date

An issuer can qualify as an EGC if it first sold its common stock in a registered offering on or after December 9 2011. The SEC has indicated that this eligibility determination is not limited to IPOs that took place on or before December 8 2011, in that it could also include an offering of common equity securities under an employee benefit plan registered on Form S-8, as well as a selling shareholder's registered secondary offering.⁸ The SEC notes that just having a registration statement declared effective on or before December 8 2011 is not a bar to EGC

status, as long as no common equity securities were actually sold pursuant to the registration statement on or before December 8 2011.⁹

Qualification for EGC status

The SEC has indicated that asset-backed issuers and registered investment companies do not qualify as EGCs; however, business development companies generally qualify.¹⁰ To date, the SEC staff has allowed business development companies and exchange-traded commodity pools to be considered EGCs. The SEC may determine, through the course of its review process or otherwise, that other particular types of issuers are not EGCs for purposes of Title I of the JOBS Act.

Previously public issuers

An issuer that succeeds to a predecessor's Exchange Act registration or reporting obligations under Rules 12g-3 and 15d-5 will not qualify for EGC status if the predecessor's first sale of common equity securities occurred on or before December 8 2011, as the predecessor was not eligible for that EGC status.¹¹

The SEC has addressed the EGC status of an issuer that was once an Exchange Act reporting company but is not required to file Exchange Act reports.¹² The SEC notes that such an issuer can take advantage of the benefits of EGC status, even though its IPO of common equity securities occurred on or before December 8 2011. In this regard, the SEC indicates that if an issuer would otherwise qualify as an EGC but for the fact that its IPO of common equity securities occurred on or before December 8 2011, and such issuer was once an Exchange Act reporting company but is not required to file Exchange Act reports, then the SEC would not object if such issuer takes advantage of all of the benefits of EGC status for its next registered offering and thereafter, until it triggers one of the disqualification provisions in

sections 2(a)(19)(A)-(D) of the Securities Act. This position is not available to an issuer that has had the registration of a class of its securities revoked pursuant to Exchange Act section 12(j). The SEC goes on to note that, based on the particular facts and circumstances, the EGC status of an issuer may be questioned if it appears that the issuer ceased to be a reporting company for the purpose of conducting a registered offering as an EGC. The SEC recommends that issuers with questions relating to these issues should contact the Division of Corporation Finance's Office of the Chief Counsel.

This interpretation seeks to address EGC status for those companies that were taken private through private equity or management buyouts with the expectation of a liquidity event or exit through an IPO in the future, which have made up a relatively significant portion of the IPO market in recent years.

Losing EGC status

Status as an EGC is maintained until the earliest of:

- The last day of the fiscal year in which the issuer's total annual gross revenues are \$1.07 billion or more;
- The last day of the issuer's fiscal year following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act (for a debt-only issuer that never sold its common equity pursuant to an Exchange Act registration statement, this five-year period will not run);
- The date on which the issuer has, during the prior three-year period, issued more than \$1 billion in non-convertible debt; or
- The date on which the issuer becomes a 'large accelerated filer', as defined in the SEC's rules.¹³

With regard to the \$1 billion debt issuance test, the SEC has indicated that the three-year period covers any rolling three-year period, which is not in any way limited to completed

calendar or fiscal years.¹⁴ The SEC also noted that it reads non-convertible debt to mean any non-convertible security that constitutes indebtedness (whether issued in a registered offering or not), thereby excluding bank debt or credit facilities.¹⁵ The debt test references debt issued, as opposed to issued and outstanding, so that any debt issued to refinance existing indebtedness over the course of the three-year period could be counted multiple times. The SEC has indicated, however, that the staff will not object if an issuer does not double count the principal amount from a private placement and the principal amount from the related Exxon Capital or A/B exchange offer.¹⁶ For issuers that engage in securitisation transactions, asset-backed debt securities issued in securitisation transactions may be counted toward the debt test to the extent that the issuer consolidates the securitisation trust on its balance sheet.

The SEC also addressed two specific examples of how the EGC status of the issuer would be determined in the event of an acquisition or reverse merger.¹⁷

- In example 1, Company A acquires Company B for cash or stock, in a forward acquisition. Company A is both the legal acquirer and the accounting acquirer.
- In example 2, Company C undertakes a reverse merger with Company D, an operating company. Company D is presented as the predecessor in the post-transaction financial statements.

In each example, the companies' fiscal year is the calendar year; the transactions occur on September 30 2012; and FAQ 24, which relates to succession of Exchange Act obligations, is not implicated. In determining whether Company A and Company C trigger any of the disqualifications from the definition of EGC in section 2(a)(19)(A), (B), (C) or (D) (referenced above), the SEC staff notes the following framework:

	Example 1: Forward Acquisition	Example 2: Reverse Merger
\$1.07 billion annual revenue test	In 2012, look to Company A's revenues for 2011. In 2013, look to Company A's revenues for 2012, which will include Company B's revenues from October 1 2012.	In 2012, look to Company D's revenues for 2011. In 2013, look to Company D's revenues for 2012, which will include Company C's revenues from October 1 2012.
Five-year anniversary test	Look to Company A's date of first sale.	Look to Company C's date of first sale.
\$1 billion issued debt during previous three years test	Look to Company A's debt issuances, which will include Company B's debt issuances from October 1 2012.	Look to Company D's debt issuances, which will include Company C's debt issuances from October 1 2012.
Large accelerated filer test	At December 31 2012, look to Company A's market value at June 30 2012. At December 31 2013, look to Company A's market value (which will include Company B's) at June 30 2013.	At December 31 2012, look to Company C's market value at June 30 2012. At December 31 2013, look to Company C's market value (which will include Company D's) at June 30 2013.

Timing of the EGC determination

Securities Act Rule 401(a) provides that ‘the form and contents of a registration statement and prospectus shall conform to the applicable rules and forms as in effect on the initial filing date of such registration statement and prospectus’, and applies to registration statements at the initial filing date, not at the time that a registration statement is submitted for confidential review.¹⁸ Therefore, an issuer must qualify as an EGC at the time of submission in order to use the confidential review process for a registration statement, or any amended submission of the registration statement. If an issuer loses EGC status while the SEC staff is reviewing the registration statement on a confidential basis, then the issuer must file the registration statement and all of the draft submissions in order to proceed with the review process. When the EGC files the registration statement, the issuer’s EGC status is retained while that registration statement is in registration by operation of Securities Act Rule 401(a). With regard to the use of the permitted test-the-waters communications under Securities Act section 5(d) (discussed below), an issuer must determine whether it qualifies as an EGC at the time it engages in the test-the-waters communications. In this respect, the SEC has noted that if the issuer later loses its EGC status by the time the registration statement is filed, then the issuer would not retroactively lose the ability to utilize prior test-the-waters communications.¹⁹

EGC grace period

The FAST Act amends the Securities Act in order to provide a grace period permitting an issuer that qualified as an EGC at the time it made its first confidential submission of its IPO registration statement and subsequently during the IPO process ceases to be an EGC to continue to be treated as an EGC through the earlier of: the date on which the issuer consummates its IPO

pursuant to that registration statement, or the end of the one-year period beginning on the date the company ceases to be an EGC.²⁰

Benefits available to EGCs

When an issuer qualifies as an EGC, it may take advantage of a number of benefits in connection with its IPO and subsequent public reporting and corporate governance. These benefits are designed to facilitate the public offering process, promote communications in and around the time of the IPO, and allow the EGC to ease into certain public reporting, accounting, auditing, and corporate governance requirements. As noted below, through its rulemaking authority, in recent years, the SEC has extended some of these benefits to all issuers.

Test-the-waters communications

Title I of the JOBS Act provides EGCs, or any other person they authorize, the flexibility to engage in oral or written communications with QIBs and IAs in order to gauge their interest in a proposed offering, whether before or following the first filing of any registration statement, subject to the requirement that no security may be sold unless accompanied or preceded by a Securities Act section 10(a) prospectus.²¹ This provision allows an EGC to test-the-waters for a potential IPO by communicating with investors and assessing their potential interest in the offering.²² An EGC can use the test-the-waters provision with respect to any registered offerings that it conducts while it qualifies as an EGC. There are no form or content restrictions on these communications, and there is no requirement to file written communications with the SEC. In the course of reviewing the registration statements of an EGC, the SEC staff has requested EGCs submit any written test-the-waters materials to the SEC, so that the SEC staff can determine whether those materials would provide any

guidance as to information that should be included in the prospectus.

In December 2019, Securities Act Rule 163B became effective. Rule 163B extends the JOBS Act's test-the-waters provisions to all issuers and permits any issuer, or any person authorized to act on its behalf, to engage in oral or written communications with potential investors that are, or are reasonably believed by the issuer to be, QIBs or IAIs, either prior to or following the filing of a registration statement, to determine whether such investors might have an interest in a contemplated registered securities offering. Rule 163B contains no legend or filing requirements but does require that test-the-waters communications not conflict with information in the registration statement for the related offering. Although the SEC acknowledged that circumstances or messaging may change between the time a pre-filing Rule 163B communication is made and a registration statement is filed, statements made in any Rule 163B communications must not contain material misstatements or omissions at the time such statements are made. Rule 163B is non-exclusive, meaning an issuer could also rely on other exclusions or exemptions to the gun-jumping rules when determining how to communicate a potential securities offering.

The SEC confirmed that an issuer could test-the-waters without such communications constituting a general solicitation and, thus, preserve its ability to pursue a private placement in lieu of a registered offering even after it tests-the-waters with respect to a registered offering. However, the SEC also cautioned that whether a Rule 163B communication would constitute a general solicitation would depend on the facts and circumstances.

With respect to Rule 163B, the SEC's adopting release makes clear that while communications benefiting from Rule 163B do not violate the Securities Act gun-jumping rules, they are considered offers under the

Securities Act and thus are subject to liability under section 12(a)(2) of the Securities Act and anti-fraud provisions such as Rule 10b-5 of the Exchange Act.

The SEC has addressed the interplay of the JOBS Act test-the-waters communications, and the requirements of Exchange Act Rule 15c2-8(e).²³ Rule 15c2-8(e) requires that a broker-dealer make available a copy of the preliminary prospectus (before the effective date) for a registered offering of securities before soliciting orders from customers. If read broadly, the prohibitions of Rule 15c2-8(e) might constrain the types of activities that are permissible during test-the-waters discussions. The FAQs note that while the JOBS Act does not amend Rule 15c2-8(e) (that is, the JOBS Act does not modify the meaning of the term 'solicit'), an EGC or a financial intermediary acting on the EGC's behalf may engage in discussions with institutional investors to gauge their interest in purchasing EGC securities before the EGC has filed its registration statement with the SEC and after the EGC has filed its registration statement. During this period, the underwriter may discuss price, volume and market demand and solicit non-binding indications of interest from customers. Soliciting such a non-binding indication of interest, in the absence of other factors, would not constitute a solicitation for purposes of Rule 15c2-8(e).

The JOBS Act also permits a broker-dealer to publish or distribute a research report about an EGC that proposes to register an offering under the Securities Act or has a registration statement pending, and the research report will not be deemed an offer under the Securities Act, even if the broker-dealer will participate or is participating in the offering. Further, no Self-Regulatory Organization (SRO) or the SEC may adopt or maintain any rule or regulation prohibiting a broker-dealer from publishing or distributing a research report or making a public appearance with respect to the securities of an EGC following an offering or in a period before expiration of a lock-up agreement.²⁴

Confidential review process for IPO registration statements

Title I provides that the SEC's staff must review all EGC IPO registration statements confidentially.²⁵ Title I provides that an EGC may confidentially submit a draft registration statement for an IPO for non-public review, provided that the initial confidential submission and all amendments are publicly filed with the SEC no later than 21 days before the issuer's commencement of a road show.²⁶ The FAST Act subsequently amended this requirement and reduced the 21-day period to a 15-day period.²⁷ The SEC requires that confidential draft registration statements and amendments be submitted through the SEC's electronic filing system (known as EDGAR) using submission form types DRS and DRS/A, respectively. No filing fee is due at the time of submitting the draft registration statement.²⁸

In June 2017, the SEC announced that as a result of a new policy it would allow all issuers (regardless of EGC status) to submit registration statements for an IPO for SEC staff review on a confidential basis. However, the confidentiality provisions applicable to EGCs are different to the confidentiality provisions applicable to all other issuers.

A confidential submission of a draft registration statement is not required to be signed by the registrant or by any of its officers or directors, nor is it required to include the consent of auditors and other experts, as it is not filed with the SEC.²⁹ While Securities Act section 6(e)(1) requires that the initial confidential submission and all amendments thereto be publicly filed with the SEC not later than 15 days before the date on which the issuer commences a road show, the SEC notes that upon public filing, the previous confidential submissions are not required to be signed and do not require consents.³⁰

The SEC expects that any registration statement submitted for confidential review will be substantially complete at the time of initial submission, including a signed audit report and

the required exhibits (however, the registration statement itself is not required to be signed or to include the consent of auditors and other experts).³¹ The SEC will defer review of any draft registration statement that is materially deficient.

The confidential submission of a draft registration does not constitute the filing of a registration statement for purposes of the prohibition in Securities Act section 5(c) against making offers of a security in advance of filing a registration statement.³²

Test-the-waters communications and the now 15-day filing requirement

The JOBS Act amended Securities Act section 6(e) to provide that confidential registration statement submissions must be publicly filed with the SEC at least 21 days before the issuer conducts a road show. As noted above, this period has since been shortened to 15 days. The term 'road show' is defined as 'an offer...that contains a presentation regarding an offering by one or more members of the issuer's management...and includes discussion of one or more of the issuer, such management, and the securities being offered'.³³ Given the breadth of this definition, the SEC has addressed the issue of whether the test-the-waters communications under Securities Act section 5(d) that are discussed above could be considered a road show for purposes of triggering this public filing requirement.³⁴

The SEC has noted that in a traditional underwritten public offering in which test-the-waters communications are not used, the road show could be easily identified as 'those meetings traditionally viewed as the road show when the EGC and underwriters begin actively marketing the offering.' Under these circumstances, the EGC would be able to estimate when it expects to begin that road show, and then publicly file the registration statement and all of the confidential submissions at least 15 days before that date. Because Securities Act section 5(d) specifically contemplates test-the-waters

communications taking place before filing a registration statement, and in the interest of reading the provisions in a consistent fashion, the SEC will not object if an EGC does not treat test-the-waters communications conducted in reliance on Securities Act section 5(d) as a road show for purposes of Securities Act section 6(e). The SEC notes, however, that if an issuer were to have meetings or other communications that meet the definition of a road show and which do not fall within the test-the-waters communications contemplated by section 5(d), then the public filing requirement would be triggered based on the timing of such meetings. If an EGC does not conduct a traditional road show and does not engage in activities that would come within the definition of a road show, other than test-the-waters communications that comply with Securities Act section 5(d), the SEC staff indicates that the issuer's registration statement and confidential submissions should be filed publicly no later than 21 days (and now, presumably, 15 days) before the anticipated date of effectiveness of the registration statement.³⁵

Similarly, when the SEC adopted Rule 163B, it also amended the definition of free writing prospectus in Rule 405 to exclude communications made in reliance on Rule 163B. Since the definition of road show is a subset of the definition of free writing prospectus, the amendment to Rule 405 effectively prevents a Rule 163B communication from being deemed a road show.

Registration statement disclosure for EGCs

The SEC has indicated that an EGC must identify itself as an EGC on the cover page of the prospectus.³⁶ In addition, SEC staff comments on EGC registration statements have requested the following disclosures:

- A description of how and when a company may lose EGC status;

- A brief description of the various exemptions that are available to an EGC, such as exemptions from Sarbanes-Oxley section 404(b) and the say-on-pay/say-on-golden parachute provisions; and
- The EGC's election under section 107(b) of the JOBS Act for extended transition to new or revised accounting standards.

The SEC staff requests that if the EGC has elected to opt out of the extended transition period for new or revised accounting standards, then it must include a statement that the election is irrevocable. If the EGC has elected to use the extended transition period, then risk factor disclosure must explain that this election allows an EGC to delay the adoption of new or revised accounting standards that have different effective dates for public and private companies until those standards apply to private companies. The SEC staff also requests that the EGC state in the risk factors that, as a result of this election, the EGC's financial statements may not be comparable to those of issuers that comply with public issuer effective dates. A similar statement is also requested in the EGC's critical accounting policy disclosures in Management Discussion & Analysis (MD&A).

An EGC is required to present only two years of audited financial statements in its IPO registration statement.³⁷ An EGC may also limit its MD&A to only cover those audited periods presented in the audited financial statements. The SEC has indicated that, notwithstanding Securities Act section 7(a)(2)(A)'s reference to 'any other' registration statement, the SEC staff will not object if an EGC presenting two years of audited financial statements limits the selected financial data included in its IPO registration statement to only two years.³⁸ For financial statements required under Rules 3-05 and 3-09 of Regulation S-X under the Securities Act (Regulation S-X), the SEC staff will not object if only two years of financial statements are provided in the registration statement, even if the significance tests result in a requirement to present three years of financial statements for entities other than the issuer.³⁹

The FAST Act also amended the financial information requirement for EGCs. As a result of the FAST Act amendments, an EGC may omit historical financial information for certain periods otherwise required by Regulation S-X at the time of filing or confidential submission, if the EGC reasonably believes the information will not be required to be included at the time of the contemplated offering.⁴⁰ In December 2015, the SEC staff provided guidance on this change, clarifying that the accommodation applies to all historical financial information required to be presented pursuant to Regulation S-X, including, for example, financial statements for an acquired company. In August 2017, the SEC staff provided additional guidance on the omission of interim information with this illustration:

For example, consider a calendar year-end EGC that submits a draft registration statement in November 2017 and reasonably believes it will commence its offering in April 2018 when annual financial information for 2017 will be required. This issuer may omit from its draft registration statements its 2015 annual financial information and interim financial information related to 2016 and 2017. Assuming that this issuer were to first publicly file in April 2018 when its annual information for 2017 is required, it would not need to separately prepare or present interim information for 2016 and 2017. If this issuer were to file publicly in January 2018, it may omit its 2015 annual financial information, but it must include its 2016 and 2017 interim financial information in that January filing because that interim information relates to historical periods that will be included at the time of the public offering.

An EGC may comply with the executive compensation disclosures applicable to a smaller reporting company as defined in the SEC's rules, which means that an EGC need provide only a Summary Compensation Table (with three rather than five named executive officers and limited to two fiscal years of information), an Outstanding Equity Awards Table, and a Director Compensation Table, along with some narrative

disclosures to augment those tables. EGCs are not required to provide a Compensation Discussion and Analysis (CD&A), or disclosures about payments upon termination of employment or change in control.⁴¹

Disclosure, corporate governance, accounting and auditing relief

Title I of the JOBS Act provides relief from a number of requirements for EGCs following an IPO. An EGC will not be subject to the say-on-pay, say-on-frequency or say-on-golden parachute vote required by the Dodd-Frank Act and the SEC rules, for as long as the issuer qualifies as an EGC.⁴² An issuer that was an EGC, but lost that status, will be required to comply with the say-on-pay vote requirement as follows: in the case of an issuer that was an EGC for less than two years, by the end of the three-year period following its IPO; and for any other issuer, within one year of having lost its EGC status.⁴³ An EGC is also not subject to any requirement to disclose the relationship between executive compensation and the financial performance of the company, or any requirement to disclose the CEO's pay relative to the median employee's pay.⁴⁴

Under section 107(b) of the JOBS Act, an EGC is not required to adopt any update to FASB's Accounting Standards codification that has different effective dates for public companies and private companies that are not 'issuers' under section 2(a) of Sarbanes-Oxley, until those standards apply to private companies. Under this provision, EGCs are able to take advantage of the extended transition period contemplated in those limited situations where there is a different effective date specified for private companies. If a new or revised accounting standard does not apply at all to private companies, then no transition would be permitted for EGCs, or if an accounting standard applies to both public and private companies, but provides for the same effective date for both types of companies, then no transition would be permitted for EGCs.

Section 107(b)(1) of the JOBS Act provides that an EGC ‘must make such choice at the time the company is first required to file a registration statement, periodic report, or other report with the Commission’ and to notify the SEC of such choice. The SEC has noted that EGCs should notify the SEC staff of the issuer’s choice at the time of the initial confidential submission, and if an EGC is already in registration or subject to Exchange Act reporting, then the statement must appear in its next amendment to the registration statement or in its next periodic report.⁴⁵ Section 107(b)(2) provides that any decision to opt out of the extended transition period for complying with new or revised accounting standards is irrevocable; however, the SEC allows an EGC that opted into the extended transition period provision to subsequently opt out, as long as it complies with the applicable provisions of the JOBS Act and discloses its opting-out in the first periodic report or registration statement following the decision to do so.

An EGC is not subject to any potential rules or standards requiring mandatory audit firm rotation or a supplement to the auditor’s report that would provide additional information regarding the audit of the company’s financial statements (auditor discussion and analysis), should such requirements ever be proposed or adopted by the Public Company Accounting Oversight Board (PCAOB). Any other new auditing standards adopted by the PCAOB will not apply to EGC audits unless the SEC determines that such requirement is necessary and appropriate for investor protection.⁴⁶

An EGC is not subject to the requirement for an auditor attestation of internal controls pursuant to section 404(b) of Sarbanes-Oxley. The EGC is subject to the requirement that management establish, maintain, and assess ICFR, once that is phased in for an issuer conducting an IPO after the first year.⁴⁷

Other than the provisions for extended transition to new or revised accounting standards discussed above, an EGC may decide to follow only some of the scaled disclosure provisions and

corporate governance accommodations available for EGCs.⁴⁸

The SEC will not object if an FPI that qualifies as an EGC complies with the scaled disclosure provisions available to EGCs to the extent relevant to the form requirements for FPIs.⁴⁹

Required studies

The JOBS Act requires that the SEC conduct a number of studies. Under Title I, within 90 days of enactment of the Act, the SEC was required to present to Congress the findings of a study that examines the impact of decimalisation on IPOs and the impact of this change on liquidity for small and mid-cap securities. If the SEC determined that securities of EGCs should be quoted or traded using a minimum increment higher than \$0.01, the SEC may, by rule, not later than 180 days following enactment of the Act, designate a higher minimum increment between \$0.01 and \$0.10.⁵⁰ Also under Title I, within 180 days of enactment, the SEC was required to present to Congress its findings and recommendations following a review of Regulation S-K that is intended to analyse current registration requirements and determine whether these requirements can be updated, modified or simplified in order to reduce costs and other burdens on EGCs.⁵¹

Decimalisation

On July 20 2012, the SEC delivered to Congress the report required by section 106 of the JOBS Act.⁵² The study notes the observations of the IPO Task Force regarding the changing market structure and economics arising from the shift to decimal stock quotes, which point toward a negative impact on the economic sustainability of sell-side research and the greater emphasis placed on liquid, very large capitalisation stocks at the expense of smaller capitalisation stocks.

The SEC's study takes a three-pronged approach to examining the issues: (i) reviewing empirical studies regarding tick size and decimalisation; (ii) participation in, and review of materials prepared in connection with, discussions concerning the impact of market structure on small and middle capitalisation companies and on IPOs as part of the SEC Advisory Committee on Small and Emerging Companies; and (iii) a survey of tick-size conventions in foreign markets.

The SEC concluded that decimalisation may have been one of a number of factors that have influenced the IPO market, and that the existing literature did not isolate the effect of decimalisation from the many other factors that have impacted the IPO market. The SEC also noted that markets have evolved significantly since decimalisation was implemented over a decade ago, and that other countries have used multiple tick sizes rather than the one-size-fits-all approach implemented in the US.

Based on the observations reported in the study, the SEC recommends that the SEC should not proceed with specific rulemaking to increase tick sizes, but should rather consider additional steps that may be needed to determine whether rulemaking should be undertaken, which might include soliciting the views of investors, companies, market professionals, academics and others on the broad topic of decimalisation and the impact on IPOs and the markets. In May 2015, the SEC approved a proposal by the national securities exchanges and the Financial Industry Regulatory Authority (FINRA) for a two-year tick size pilot program that had as its objective assessing whether wider tick sizes enhance market quality for the securities of small cap companies. The pilot program will run for at least two years and will include stocks of companies with \$3 billion or less in market capitalisation, an average daily trading volume of one million shares or less, and a volume-weighted average price of at least \$2 for every trading day. On July 3 2018, the SEC and FINRA released a joint assessment of the pilot program.⁵³

Regulation S-K

On December 23 2013, the SEC delivered to Congress the report required by section 108 of the JOBS Act.⁵⁴ The SEC was mandated to review Regulation S-K in the context of the new class of issuers referred to in the JOBS Act as EGCs. In connection with this review, the SEC staff chose to consider the background of the development of disclosure requirements and potential recommendations for revisiting disclosure requirements more generally. The SEC staff reviewed, among other things, Regulation S-K, SEC releases and comment letters on SEC regulatory actions pertaining to Regulation S-K. The SEC staff also reviewed public comments that were submitted regarding section 108 of the JOBS Act. In light of the focus of the mandate in section 108 of the JOBS Act, the SEC staff did not review two subparts of Regulation S-K, Regulation AB and Regulation M-A.

The SEC staff noted that while the study conducted in connection with the section 108 report serves as an important starting point, further information-gathering and review is warranted in order to formulate specific recommendations regarding specific disclosure requirements. The SEC staff stated that 'input from market participants is needed to facilitate the identification of ways to update or add requirements for disclosure that is material to an investment or voting decision, ways to streamline and simplify disclosure requirements to reduce the costs and burdens on public companies, including EGCs, ways to enhance the presentation and communication of information and to understand how technology can play a role in addressing any of these issues.' In addition, the SEC staff noted in the report that economic analysis is necessary to inform any re-evaluation of disclosure requirements.

The SEC staff recommended the development of a plan to systematically review the SEC's disclosure requirements for public companies, including Regulations S-K and S-X, and the related rules concerning the presentation and

delivery of information. Among the factors that will be considered in the review are disclosure requirements developed through SEC interpretations, as well as external factors that may have contributed to the length and complexity of filings and the costs of compliance (e.g., SEC enforcement actions and judicial opinions). After conducting this detailed review, the SEC staff would make specific recommendations for proposed rule and form changes.

The SEC staff has identified two alternative frameworks for structuring such a review: a comprehensive approach and a targeted approach. The SEC staff believes that any such review could be more effective if it were to:

- Emphasize a principles-based approach as a critical aspect of the disclosure framework;
- Evaluate the appropriateness of current scaled disclosure requirements and whether further scaling would be appropriate for EGCs or other categories of issuers;
- Evaluate methods of information delivery and presentation, through both the EDGAR system and other means; and
- Consider ways to present information that would improve the readability and navigability of disclosure documents, as well as discouragement of repetition and the disclosure of immaterial information.

The SEC's Division of Corporation Finance has been actively engaged in its disclosure effectiveness review for a number of years. As part of this review, the Division is considering the disclosure requirements in Regulation S-K and Regulation S-X, and assessing whether such requirements are outdated, repetitive, or can otherwise be revised in order to improve disclosures made by public companies. In April 2016, the SEC moved forward in its review of Regulation S-K requirements by issuing a Concept Release requesting comment on the business and financial disclosures that public companies provide in their Exchange Act filings. The Concept Release did not comment specifically on the other disclosure requirements of Regulation S-K, such as corporate governance

or compensation-related items, or the required disclosures for FPIs, business development companies or other types of registrants. During 2016, the SEC requested comment on other aspects of Regulation S-K through four other releases.

Since then, the SEC has taken a number of steps to update and modernize the disclosure requirements in Regulation S-K. For example, in August 2018, the SEC adopted disclosure updates and simplification amendments, primarily relating to MD&A and financial statement disclosures, which became effective in November 2018. In March 2019, the SEC adopted additional modernisation and simplification amendments, primarily focusing on other provisions of Regulation S-K, which became effective in May 2019. In August 2019, the SEC proposed additional amendments to certain sections of Securities Act and Exchange Act filings, including the description of business, legal proceedings, and risk factors requirements of Regulation S-K.

The FAST Act included a few provisions requiring the SEC to take actions within 180 days of the statute's enactment to permit issuers to submit a summary page on Form 10-K that cross-references related disclosures included throughout the form. It also required that the SEC revise Regulation S-K in order to further scale or eliminate requirements to ease the burden on EGCs, accelerated filers, smaller reporting companies and other smaller issuers, while still providing all material information to investors and to eliminate provisions of Regulation S-K required for all issuers, which provisions are duplicative, overlapping, outdated or unnecessary, and for which the SEC determines no further study is necessary to determine the efficacy of such revisions to Regulation S-K. The FAST Act also requires the SEC to conduct another study (this time within 360 days of the statute's enactment) to determine how to best modernize and simplify Regulation S-K in a manner that reduces the costs and burdens to issuers while still providing all material information.⁵⁵ In November 2016, the

SEC Staff released its ‘Report on Modernization and Simplification of Regulation S-K’, as required by the FAST Act addressing specific recommendations to modernize and simplify the Regulation S-K requirements. In October 2017, the SEC proposed comment amendments to Regulation S-K to implement the recommendations made in its 2016 report. In March 2019, the SEC adopted a number of amendments that simplified certain disclosure requirements in Regulation S-K and related rules and forms. The majority of these amendments became effective in May 2019. Data tagging using XBRL becomes effective in different phases with the final phase taking effect in June 2021.

The SEC remains committed to advancing its disclosure effectiveness initiative and it is safe to predict that there will be additional amendments to Regulation S-K and Regulation S-X that have as their principal objective modernising the disclosure requirements, reducing duplicative or outdated disclosure requirements, and promoting capital formation.

**Appendix A
DISCLOSURE AND RELATED REQUIREMENTS**

	Before the JOBS Act	Under the JOBS Act and subsequent rulemaking
Financial information in SEC filings	<ul style="list-style-type: none"> • Three years of audited financial statements; • Two years of audited financial statements for smaller reporting companies; and • Selected financial data for each of five years (or for life of issuer, if shorter) and any interim period included in the financial statements 	<ul style="list-style-type: none"> • Two years of audited financial statements; • Certain financial statements may be omitted from confidential submissions and filings if these will not be required to be included at the time of consummation of the IPO; • Not required to present selected financial data for any period before the earliest audited period presented in connection with an IPO; and • Within one year of IPO, EGC would report three years of audited financial statements
Confidential submissions of draft IPO registration statement	<ul style="list-style-type: none"> • No confidential filing for US issuers; and • Confidential filing for FPIs only in specified circumstances 	<ul style="list-style-type: none"> • All issuers may submit a draft IPO registration statement for confidential review before public filing, provided that such submission and any amendments are publicly filed with the SEC not later than 15 days before the issuer conducts a road show.
Communications before and during offering process	<ul style="list-style-type: none"> • No confidential filing for US issuers; and • Limited ability to test-the-waters 	<ul style="list-style-type: none"> • Issuers, either before or after filing a registration statement, may test-the-waters by engaging in oral or written communications with QIBs and in IAs to determine interest in an offering

	Before the JOBS Act	Under the JOBS Act and subsequent rule making
Auditor attestation on internal controls	<ul style="list-style-type: none"> • Auditor attestation on effectiveness of internal controls over financial reporting required in second annual report after IPO; and • Non-accelerated filers not required to comply 	<ul style="list-style-type: none"> • Transition period for compliance of up to five years
Accounting standards	<ul style="list-style-type: none"> • Must comply with applicable new or revised financial accounting standards 	<ul style="list-style-type: none"> • Not required to comply with any new or revised financial accounting standard until such standard applies to companies that are not subject to Exchange Act public company reporting; and • EGCs may choose to comply with non-EGC accounting standards but may not selectively comply
Executive compensation disclosure	<ul style="list-style-type: none"> • Must comply with executive compensation disclosure requirements, unless a smaller reporting company (which is subject to reduced disclosure requirements); and • Upon adoption of SEC rules under Dodd-Frank will be required to calculate and disclose the median compensation of all employees compared to the CEO 	<ul style="list-style-type: none"> • May comply with executive compensation disclosure requirements by complying with the reduced disclosure requirements generally available to smaller reporting companies; • Exempt from requirement to calculate and disclose the median compensation of all employees compared to the CEO; and • FPIs entitled to rely on other executive compensation disclosure requirements
Say-on-pay	<ul style="list-style-type: none"> • Must hold non-binding advisory stockholder votes on executive compensation arrangements; and • Smaller reporting companies are exempt from say-on-pay 	<ul style="list-style-type: none"> • Exempt from requirement to hold non-binding advisory stockholder votes on executive compensation arrangements for one to three years after no longer an EGC

ENDNOTES

- 1 Frequently Asked Questions of General Applicability on Title I of the JOBS Act (Apr 16 2012, May 3 2012, Sep 28 2012 and Dec 21 2015), available at www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm (SEC Title I FAQs).
- 2 Securities Act section 2(a)(19), 15 USC 77b(a).
- 3 SEC Title I FAQs, supra note 1 at Question 1.
- 4 Id.
- 5 Id.
- 6 SEC Title I FAQs, supra note 1 at Question 23, referencing section 5110.2(c) of the Division of Corporation Finance Financial Reporting Manual, available at www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf.
- 7 SEC Title I FAQs, supra note 1 at Question 51.
- 8 SEC Title I FAQs, supra note 1 at Question 2.
- 9 Id.
- 10 SEC Title I FAQs, supra note 1 at Questions 19-21.
- 11 SEC Title I FAQs, supra note 1 at Question 24.
- 12 SEC Title I FAQs, supra note 1 at Question 54.
- 13 Securities Act section 2(a)(19), 15 USC 77b(a).
- 14 SEC Title I FAQs, supra note 1 at Question 17.
- 15 Id.
- 16 SEC Title I FAQs, supra note 1 at Question 18.
- 17 SEC Title I FAQs, supra note 1 at Question 47.
- 18 SEC Title I FAQs, supra note 1 at Question 3.
- 19 Id.
- 20 Section 71002 of the FAST Act, amending section 6(e)(1) of the Securities Act.
- 21 JOBS Act section 105(c), amending Securities Act section 5, 15 USC 77e.
- 22 Without the availability of the test-the-waters provisions in Securities Act section 5(d) or Rule 163B, an issuer could potentially be deemed to be ‘gun-jumping’ when communicating with investors about an actual or potential offering, based on the timing and nature of such communications.
- 23 Frequently Asked Questions About Research Analysts and Underwriters (Aug 22 2012), available at www.sec.gov/divisions/marketreg/tmjobsact-researchanalystsfaq.htm, at Question 1.
- 24 Sections 105(c) and 105(d) of the JOBS Act.
- 25 Section 106(a) of the JOBS Act, amending Securities Act section 6, 15 USC 77(f). An FPI that qualifies as an EGC may opt to use the Division of Corporation Finance’s policy titled Non-Public Submissions from Foreign Private Issuers if it meets the circumstances that the Division has outlined in that policy, available at www.sec.gov/divisions/corpfin/international/nonpublicsubmissions.htm.
- 26 For this purpose, the term road show is defined in Securities Act Rule 433(h)(4).
- 27 Section 71001 of the FAST Act.
- 28 Frequently Asked Questions on the Confidential Submission Process for Emerging Growth Companies (Apr 10 2012), available at <https://www.sec.gov/divisions/corpfin/guidance/cfjumpstartfaq.htm> (SEC Confidential Submission FAQs) at Question 5.
- 29 SEC FAQs, supra note 1 at Question 52.
- 30 Id.
- 31 SEC Confidential Submission FAQs, supra note 28, Question 7.
- 32 SEC Confidential Submission FAQs, supra note 28, Question 6.
- 33 Securities Act Rule 433(h)(4).
- 34 SEC Confidential Submission FAQs, supra note 28, Question 8.
- 35 SEC Confidential Submission FAQs, supra note 28, Question 9.
- 36 SEC Title I FAQs, supra note 1, Question 4.
- 37 Securities Act section 7(a)(2)(A), 15 USC 77g(a)(2)(A).
- 38 SEC Title I FAQs, supra note 1 at Question 11. The SEC would not object if an issuer that has lost its EGC status does not present, in subsequently filed registration statements and periodic reports, selected financial data or a ratio of earnings to fixed charges for periods before the earliest audited period presented in its initial Securities Act or Exchange Act registration statement. See SEC

- Title I FAQs, *supra* note 1 at Question 50.
- 39 SEC Title I FAQs, *supra* note 1 at Question 16.
- 40 SEC Title I FAQs, *supra* note 1 at Question 27.
- 41 Section 71003 of the FAST Act.
- 42 JOBS Act section 102(c).
- 43 Exchange Act section 14A(e), 15 USC 78n-1(e).
- 44 *See* Dodd-Frank Act section 953(b)(1).
- 45 SEC Title I FAQs, *supra* note 1 at Question 13.
- 46 JOBS Act section 104, amending Sarbanes-Oxley Act section 103(a)(3).
- 47 JOBS Act section 103, amending Sarbanes-Oxley Act section 404(b).
- 48 JOBS Act section 107.
- 49 SEC Title I FAQs, *supra* note 1 at Question 8.
- 50 JOBS Act section 106(b).
- 51 JOBS Act section 108.
- 52 Report to Congress on Decimalization (Jul 2012), available at www.sec.gov/news/studies/2012/decimalization-072012.pdf.
- 53 Assessment of the Plan to Implement a Tick Size Pilot Program, available at <https://www.sec.gov/files/TICK%20PILOT%20ASSESSMENT%20FINAL%20Aug%2002.pdf>.
- 54 Report on Review of Disclosure Requirements in Regulation S-K (Dec 2013), available at www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf.
- 55 FAST Act Modernization and Simplification of Regulation S-K, available at <https://www.sec.gov/info/smallbus/secg/fast-act-modernization-and-simplification-of-regulation-s-k>.

CHAPTER 2

The IPO process

As we discussed in the introduction, there are important considerations to be analysed in connection with pursuing an IPO. Even given many changes in the capital markets and the improved liquidity of private or restricted securities, there are significant advantages to be gained as a result of being a public company. Aside from the immediate capital-raising opportunity of the IPO, which may be valuable to an issuer that cannot access private capital, going public will create a liquid public market for the issuer's securities. The issuer's security holders will have an opportunity to monetize their investment in the company. The issuer also will have an acquisition currency and be able to use its stock as consideration in a strategic transaction.

After its IPO, the issuer also will have many more capital-raising alternatives. All of these advantages will have to be weighed carefully against the costs of undertaking an IPO, as well as the burdens and expenses of life as a public company. A bit of this calculus has been made

easier under the JOBS Act for EGCs, which receive certain benefits including scaled disclosure accommodations and phase-in periods for complying with many corporate governance requirements, resulting in important cost savings as well as giving EGCs an opportunity to ease into life as a public company. EGCs have the flexibility of adding additional staff or retaining service providers before it has to comply with some of the more burdensome corporate governance and reporting requirements. In addition, under the JOBS Act, EGCs have the opportunity to pursue an IPO through an initial confidential submission process, an accommodation that the SEC extended to all issuers, not just EGCs, in July 2017. Should the issuer determine that the market will not be receptive to its IPO, or that other alternatives are more appealing, it can withdraw from the process without alerting the market of its proposed offering and avoiding the stigma of a failed deal.

With respect to EGCs, the JOBS Act has changed some of the dynamics that might

figure into a company's decision-making about undertaking an IPO as well as the IPO process itself. Below we briefly discuss the IPO process and highlight a number of the most important decisions that an EGC should consider, as well as the opportunities for an issuer that qualifies as an FPI, arising from the JOBS Act.

Pre-IPO planning

Before determining to undertake an IPO and committing to proceed with filing a registration statement with the SEC, companies must undertake a fair bit of planning, even if the company intends to submit its IPO registration statement through the confidential submission process. Even though the JOBS Act provides for certain reduced disclosure requirements for EGCs, a company must be prepared for a time-consuming process.

Most companies will have to make legal and operational changes before proceeding with an IPO. A company cannot wait to see if its IPO is likely to be successful before implementing most of these changes. Many corporate governance matters, federal securities law requirements (including Sarbanes-Oxley requirements), as well as applicable securities exchange requirements must be met when the IPO registration statement is publicly filed, or the issuer must commit to satisfy them within a set time period.

A company proposing to list securities on an exchange, such as the New York Stock Exchange (NYSE) or Nasdaq Stock Market, should review the differing governance requirements of each exchange, as well as their respective quantitative listing requirements, before determining which exchange to list its securities on. An issuer must also address other corporate governance matters, including board structure, committees and member criteria, related party transactions, and directors' and officers' liability insurance. Similarly, an issuer will want to consider whether to retain

additional senior management or enter into employment agreements with key executive officers and systematize its compensation practices. The company should undertake a thorough review of its compensation scheme for its directors and officers as well, particularly its use of equity compensation. The issuer also will want to review all prior securities issuances for compliance with federal and state securities laws, including the limits of Rule 701 of the Securities Act.

Primary and secondary offerings

An IPO may consist of the sale of newly issued shares by the company (a primary offering), or a sale of already issued shares owned by shareholders (a secondary offering), or a combination of these. Underwriters may prefer a primary offering because the company will retain all of the proceeds to invest in its business. However, many IPOs include secondary shares, either in the initial part of the offering or as part of the 15% over-allotment option granted to underwriters. Venture capital and private equity shareholders view a secondary offering as their principal realisation event. An issuer also must consider whether any of its shareholders have registration rights that could require the issuer to register shareholder shares for sale in the IPO.

The 'private IPO' before the IPO

As privately-held companies remain private longer and defer their IPOs, these companies are increasingly reliant on raising capital in successive private placements. New categories of investors, including cross-over funds, sovereign wealth funds, and family offices, have become significant participants in late-stage (or mezzanine) private placements, along with insiders (*i.e.*, directors, officers, and significant holders). Depending on the sector, a late-stage private placement may be

an important step for a company. For example, a late-stage private placement may provide needed capital to allow the company to defer its IPO until the IPO market becomes more hospitable. A transaction involving the sale of securities held by existing holders may provide liquidity to friends and family, angel, and other early investors in the company. In the tech sector, many market participants have observed that late-stage private placements have become the ‘new IPOs’. Given that private capital has been readily available, especially for promising privately-held companies, at attractive valuations, many unicorns have chosen to raise larger late-stage private rounds. Investors in private rounds may be benefitting from the value creation that would have been experienced in the years immediately following a company’s IPO.

Cheap stock

Cheap stock describes options granted to employees of a pre-IPO company during the 18 to 24 months before the IPO where the exercise price is deemed (in hindsight) to be considerably lower than the fair market value of the shares at grant date. If the SEC determines (during the comment process) that the company has issued cheap stock, the company must incur a compensation expense that will have a negative impact on earnings. The earnings impact may result in a significant one-time charge at the time of the IPO as well as going-forward expenses incurred over the option vesting period. In addition, absent certain limitations on exercisability, an option granted with an exercise price that is less than 100% of the fair market value of the underlying stock on the grant date will subject the option holder to an additional 20% tax pursuant to section 409A of the US Internal Revenue Code.

The dilemma that a private company faces is that it is unable to predict with certainty the eventual IPO price. A good-faith pre-IPO fair market value analysis can yield different

conclusions when compared to a fair market value analysis, conducted by the SEC in hindsight based on a known IPO price. There is some industry confusion as to the acceptable method for calculating the fair market value of non-publicly traded shares and how much deviation from this value is permitted by the SEC. Companies often address this cheap stock concern by retaining an independent appraiser to value their stock options. However, it now appears that most companies are using one of the safe-harbor methods for valuing shares prescribed in the section 409A regulations.

Governance and board members

Even with the accommodations available to an EGC, a company still must comply with significant corporate governance requirements imposed by the federal securities laws and regulations and the regulations of the applicable exchanges, including the oversight responsibilities of the board of directors and its committees. A critical matter is the composition of the board itself. All exchanges require that, except under limited circumstances, a majority of the directors be ‘independent’ as defined by both the federal securities laws and regulations and the exchange regulations. In addition, boards should include individuals with appropriate financial expertise and industry experience, as well as an understanding of risk management issues and public company experience. A company should begin its search for suitable directors early in the IPO process even if it will not appoint the directors until after the IPO is completed. The company can turn to its large investors as well as its counsel and underwriters for references regarding potential directors.

The Sarbanes-Oxley and Dodd-Frank Acts require publicly traded companies to implement corporate governance policies and procedures that are intended to provide

minimum structural safeguards to investors. Certain of these requirements are phased in after the IPO, and some requirements have been made less burdensome for EGCs under the JOBS Act.

Key provisions include:

- requirements related to the company's ICFR, including (1) management's assessment and report on the effectiveness of the company's internal controls on an annual basis, with additional quarterly review obligations, and (2) audit of the company's ICFR by its independent registered public accounting firm. However, a company will not need to comply with the auditor attestation requirement as long as it qualifies as an EGC or a non-accelerated filer;
- prohibition of most loans to directors and executive officers (and equivalents thereof);
- the CEO and CFO of a public company must certify each SEC periodic report containing financial statements;
- adoption of a code of business conduct and ethics for directors and senior executive officers;
- required real time reporting of certain material events relating to the company's financial condition or operations;
- disclosure of whether the company has an audit committee financial expert serving on its audit committee;
- disclosure of material off-balance sheet arrangements and contractual obligations;
- audit committee approval of any services provided to the company by its audit firm, with certain exceptions for *de minimis* services;
- whistleblower protections for employees who come forward with information relating to federal securities law violations; and
- compensation disgorgement provisions applicable to the CEO and CFO upon a restatement of financial results attributable to misconduct.

In addition, the exchanges' listing requirements contain related substantive corporate governance requirements regarding independent directors; audit, nomination, and compensation committees; and other matters.

Selecting the underwriters

A company will identify one or more lead underwriters that will be responsible for the IPO. A company generally chooses an underwriter based on its industry expertise, including the knowledge and following of its research analysts, the breadth of its distribution capacity, and its overall reputation. A company should consider the underwriter's commitment to the sector and its distribution strengths. For example, does the investment bank have particularly strong research coverage? Does it have a retail distribution network, or is it focused on institutional distribution? Are its strengths domestic, or does it have foreign distribution capacity? The company may want to include a number of co-managers in order to balance the underwriters' respective strengths and weaknesses. In recent years, the trend has been toward including a significant number of co-managers and managers in IPOs. The number of syndicate members will depend, to some extent, on the size of the IPO.

A company should keep in mind that underwriters have at least two conflicting responsibilities: to sell the IPO shares on behalf of the company (and/or the selling shareholders) and to recommend to potential investors that the purchase of the IPO shares is a suitable and worthy investment. In order to better understand the company – and to provide a defense in case the underwriters are sued in connection with the IPO – the underwriters and their counsel are likely to spend a substantial amount of time performing business, financial, and legal due diligence in connection with the IPO and making sure that the prospectus and any other offering materials are consistent with the information provided. The

underwriters will market the IPO shares, set the price (in consultation with the company) at which the shares will be offered to the public, and, in a ‘firm commitment’ underwriting, purchase the shares from the company and then re-sell them to investors. In order to ensure an orderly market for the IPO shares, after the shares are priced and sold, the underwriters are permitted, in many circumstances, to engage in certain stabilising transactions to support the stock.

The IPO process

The IPO process is divided into three periods:

- **Pre-filing period** The period between determining to proceed with an IPO and the actual SEC filing of the registration statement. During the pre-filing period, the company is in the ‘quiet period’ and subject to potential limits on public disclosure relating to the offering;
- **Waiting period** The waiting or pre-effective period is the period between the SEC filing date and the effective date of the registration statement. During the waiting period, the company continues to be in the ‘quiet period’, but may make oral offers and perform ‘road shows’ that allow information to be presented to prospective investors and the investment community. However, the company cannot enter into binding agreements to sell the offered security; and
- **Post-effective period** The period between effectiveness of the registration statement and the completion of the offering.

The registration statement

A registration statement contains the prospectus, which is the primary selling document, as well as other required information, written undertakings of the issuer and the signatures of the issuer and the majority of the issuer’s directors. It also

contains exhibits, including basic corporate documents and material contracts. US companies generally file a registration statement on Form S-1. Most non-Canadian FPIs use a registration statement on Form F-1, although other forms may be available. There are special forms available to certain Canadian companies.¹

The prospectus

The prospectus describes the offering terms, the anticipated use of proceeds, the company, its industry, business, management and ownership, and its results of operations and financial condition. Although it is principally a disclosure document, the prospectus also is crucial to the selling process. A good prospectus sets forth the investment proposition.

As a disclosure document, the prospectus functions as an insurance policy of sorts in that it is intended to limit the issuer’s and underwriters’ potential liability to IPO purchasers. If the prospectus contains all SEC-required information, includes robust risk factors that explain the risks that the company faces, and has no material misstatements or omissions, investors will not be able to recover their losses in a lawsuit if the price of the stock drops following the IPO. A prospectus should not include puffery or overly optimistic or unsupported statements about the company’s future performance. Rather, it should contain a balanced discussion of the company’s business, along with a detailed discussion of risks and operating and financial trends that may affect its results of operations and prospects.

SEC rules set forth a substantial number of specific disclosures required to be made in the prospectus. In addition, federal securities laws, particularly Rule 10b-5 under the Exchange Act, require that documents used to sell a security contain all the information material to an investment decision and do not omit any information necessary to avoid misleading

potential investors. Federal securities laws do not define materiality; the basic standard for determining whether information is material is whether a reasonable investor would consider the particular information important in making an investment decision. That simple statement is often difficult to apply in practice.

We noted that one of the principal benefits of the IPO on-ramp approach is that an EGC may choose to rely on some of the disclosure accommodations made available by Title I of the JOBS Act. EGCs have the option of relying on the smaller reporting company scaled disclosure requirements for executive compensation. This means, for example, that an EGC could omit a CD&A section and present only a summary compensation table. An EGC may decide to include more substantial executive compensation disclosures in its future filings. An EGC should consult with its counsel, as well as with the underwriters, regarding these disclosures.

Although the JOBS Act provides for certain reduced disclosure requirements for EGCs, an issuer should be prepared for the time-consuming drafting process, during which the issuer, underwriters, and their respective counsel work together to craft the prospectus disclosures.

Financial information

The JOBS Act significantly reduced the extent of financial reporting required in an IPO registration statement. The IPO registration statement for an EGC must include audited financial statements for the last two fiscal years (three years for a non-EGC); financial statements for the most recent fiscal interim period, comparative with interim financial information for the corresponding prior fiscal period (which may or may not be audited depending on the circumstances); and income statement and condensed balance sheet information for the last two years (five years for

a non-EGC) and interim periods presented. An EGC and its counsel will want to consider whether the EGC will want to take advantage of these disclosure accommodations or present information for a third year even though it is not required. In some cases, the underwriter will have strong views regarding the information that should be presented in the registration statement. For example, the underwriter may take the view that the issuer's competitors that are already SEC-reporting companies provide financial information for a longer period and it will be important to investors that the EGC provide comparable information. The underwriter may believe that institutional investors in that industry sector may demand three years of financial information. It may be the case that there are important trends in either the issuer's business and results of operations or in the industry as a whole that make it important to present three years of information in order to ensure that an investor will be able to evaluate all of the information that may be deemed material to an investment decision, including, perhaps, trends in the issuer's business or in the industry.

Additionally, an EGC may omit financial information for historical periods that otherwise would be required at the time of filing or submission, provided that the omitted financial information will not be required to be included in the registration statement at the time of the consummation of the offering. In August 2017, the SEC staff issued guidance clarifying that an EGC may omit from its draft registration statements interim financial information that it reasonably believes it will not be required to present at the time of the offering², however interim financial information that will be included in a historical period that a non-EGC reasonably believes will be required to be included at the time of its first public filing may not be omitted from its filed registration statements.³

Early on, the issuer should identify any problems associated with providing the

required financial statements in order to seek necessary accommodation from the SEC. These statements must be prepared in accordance with US GAAP for a domestic company or IFRS as adopted by the IASB for a non-domestic company, as they will be the source of information for the MD&A. The SEC will review and comment on the financial statements and the MD&A. The SEC's areas of particular concern include: revenue recognition; business combinations; segment reporting; financial instruments; impairments of all kinds; deferred tax valuation allowances; compliance with debt covenants; fair value; loan losses; and non-GAAP financial measures.

Finally, an EGC will have to decide whether it will opt out of the extended transition period provided for an EGC to comply with new or revised accounting standards. An EGC's decision in this regard is irrevocable and will have to be disclosed in its registration statement. Here, again, the issuer will want to consider this decision carefully and discuss it with its counsel and its auditors. The underwriter may also have a view.

The pre-filing period

The pre-filing period begins when the company and the underwriters agree to proceed with a public offering. During this period, key management personnel will generally make a series of presentations covering the company's business and industry, market opportunities, and financial matters. The underwriters will use these presentations as an opportunity to ask questions and establish a basis for their due diligence defense.

From the first all-hands meeting forward, all statements concerning the company should be reviewed by the company's counsel to ensure compliance with applicable rules. Communications by an issuer more than 30 days before filing a registration statement are permitted as long as they do not reference the securities offering. Statements made within 30 days of filing

a registration statement that could be considered an attempt to pre-sell the public offering may be considered an illegal prospectus, creating a gun-jumping violation. This might result in the SEC delaying the public offering or requiring prospectus disclosures of these potential securities law violations. Press interviews, participation in investment banker-sponsored conferences, and new advertising campaigns are generally discouraged during this period.

Under the JOBS Act, however, an EGC (or its designated representatives) may engage in 'test-the-waters' communications with certain investors (such as QIBs and IAs) to gauge interest in the offering during both the pre-filing period and after filing. The company should consult with its counsel and the underwriters before engaging in any 'test-the-waters' communications. The SEC will also ask to review copies of any written materials used for this purpose. In September 2019, the SEC adopted new Rule 163B, which expanded the permitted use of testing-the-waters communications to all companies, not just EGCs. The new rule took effect on December 2019.

In general, at least four to six weeks will pass between the distribution of a first draft of the registration statement and its filing with the SEC. To a large extent, the length of the pre-filing period will be determined by the amount of time required to obtain the required financial statements.

Confidential submission process

As explained in Chapter 1, an EGC may make a confidential submission of its registration statement to the SEC for its review. This allows the company to work through the SEC comment process (discussed below) without the glare of publicity and without competitors becoming aware of the proposed offering. The confidentially submitted draft registration statement is not required to be signed by the issuer and its officers or directors, nor is it required to contain a signed auditor's consent.

However, the submission should be a materially complete submission, as the SEC might decide not to review a registration statement that is deemed incomplete or materially deficient, slowing down the offering process. Furthermore, the company must publicly file the confidentially submitted registration statement, along with all amendments, at least 15 days before the start of any road show. As a result, the issuer, its advisers and the entire working group should approach the preparation of a confidential submission with the same rigour as they would approach the preparation of a registration statement that will be publicly filed and available to all, including the issuer's competitors.

In June 2017, the SEC's Division of Corporation Finance announced a new policy effective July 2017 that essentially extends the confidential submission process to all issuers while keeping the EGC process unchanged. The SEC will review a draft initial registration statement under the Securities Act, and related revisions on a non-public basis. Similarly, the SEC also will now review a draft registration statement of a class of securities under section 12(b) of the Exchange Act. The SEC will also accept draft registration statements submitted prior to the end of the twelfth month following the effective date of an issuer's initial Securities Act registration statement or an issuer's Exchange Act section 12(b) registration statement for non-public review.

There are few, if any, disadvantages to the confidential submission process. The issuer will have greater flexibility to control the timing of the offering. If the market seems inhospitable to an offering, the issuer may decide to delay the process and will not subject itself to public scrutiny for doing so. If the issuer needs to withdraw the filing, again, it will be able to do so without the stigma associated with a failed or withdrawn offering.

An issuer and its bankers and advisers may not, however, have as much insight into the IPO market given the confidential filing

process. For example, bankers may not be aware of competitors that also are pursuing IPOs because the competitors also may be proceeding with their offerings on a confidential basis. Often having information about other companies in the IPO queue may be important because it may factor into decisions on timing of marketing the deal, as well as decisions regarding valuation.

Sometimes an issuer will decide to pursue a dual-track approach, whereby it will decide to undertake an IPO and also concurrently consider M&A alternatives. A dual-track process can be very useful during periods of heightened market volatility in which the IPO market is uncertain. In addition, the IPO filings can often serve to make acquisitive competitors that may be interested in new opportunities aware of the issuer and the issuer's performance. It may be more difficult to pursue a dual-track strategy during the confidential submission process. Of course, an issuer that is relying on the confidential submission process may choose to make an announcement regarding its intentions to pursue an IPO, and a few companies have issued such press releases. Since the confidentiality obligation rests with the SEC, and not with the issuer, a press release of this sort is permissible, although it should be considered carefully given that it undoes many of the benefits associated with the confidential process.

Testing-the-waters

The JOBS Act provides an EGC or any other person, such as its underwriter, that it authorizes to act on its behalf with the flexibility to engage in oral or written communications with QIBs and IALs in order to gauge their interest in a proposed offering, whether before (irrespective of the 30-day communications safe harbor) or following the first filing of any registration statement, subject

to the requirement that no security may be sold unless accompanied or preceded by a section 10(a) prospectus.

There are no form or content restrictions on these communications, and there is no requirement to file written communications with the SEC. The SEC staff will ask to see any written test-the-waters materials during the course of the registration statement review process to determine whether those materials provide any guidance as to information that the SEC staff believes should be included in the prospectus.

In order to make written offers, a company must first file (not just submit) its registration statement with the SEC and have a preliminary prospectus available, irrespective of the expected commencement of the road show. This requirement applies to EGCs and non-EGCs, since the JOBS Act did not amend section 5(b)(1) of the Securities Act, which requires that written offers must include the information required by section 10. In the pre-filing period, test-the-waters communications must be limited to QIBs and IAIs.

Before engaging in any test-the-waters discussions, a company should consult with its counsel and coordinate closely with the underwriter. As noted below, during the comment process, the SEC staff will ask whether the issuer engaged in testing-the-waters and will want to see any written materials used for this purpose. In addition, as we discuss below, issuer's counsel and the underwriter and its counsel will want an opportunity to review and comment on the material. Any written materials used for this purpose should be consistent with the information included in the issuer's registration statement. An issuer will also want to be certain that the issuer is not sharing any information that may be deemed confidential in the course of these discussions. An investor approached during this phase generally will not want to be in possession of any information that will remain confidential, and that may be material, even following the issuer's IPO. In addition, as discussed further below, an issuer will be required to make certain representations and warranties to the

underwriters in the underwriting agreement relating to any test-the-waters activities and materials.

Many companies contemplating an IPO in the United States, especially FPIs, were surprised by the restrictions on offering related communications imposed by SEC regulations. Critics noted that these communications restrictions limited an issuer's opportunity to reach potential investors early in the process and, therefore, an issuer was forced to incur significant expense in pursuing an IPO and might not have any information about the level of investor interest and potential valuations until the road show.

In other jurisdictions, especially in Europe and Asia, issuers and the financial intermediaries acting on their behalf have considerably more flexibility. Often in European or Asian offerings, a lead or cornerstone investor might be secured early in the offering process. As a result of these concerns, the ability to conduct test-the-waters communications was well received. To the extent that companies are benefiting from the enhanced flexibility, more often than not, the test-the-waters conversations are taking place shortly before the commencement of the road show, and not early in the offering process.

It is also important to remember that the test-the-waters flexibility still is more limited than the approach that may be familiar to FPIs. As noted in Chapter 1, during the test-the-waters phase a company may engage in discussions with institutional investors but the company and the underwriter cannot obtain a purchase commitment. The underwriter may discuss price, volume and market demand and solicit non-binding indications of interest from customers.

The waiting period

Responding to SEC comments on the registration statement

An integral part of the IPO process is the SEC's review of the registration statement. Once the registration statement is filed or confidentially submitted, a team of SEC staff members is

assigned to review the filing. The team consists of accountants and lawyers, including examiners and supervisors. The SEC's objective is to assess the company's compliance with its registration and disclosure rules. The SEC review process should not be viewed as a 'black box' where filings go in and comments come out; rather, as with much of the IPO process, the relationship with the SEC is a collaborative process.

The SEC's principal focus during the review process is on disclosure. In addition to assessing compliance with applicable requirements, the SEC considers the disclosures through the eyes of an investor in order to determine the type of information that would be considered material. The SEC's review is not limited to the registration statement. The SEC staff will closely review websites, databases, and magazine and newspaper articles, looking in particular for information that the SEC staff thinks should be in the prospectus or that contradicts information included in the prospectus.

The SEC targets 30 calendar days from the registration statement filing or confidential submission date to respond with comments. However, the timing can depend on the SEC's workload and the complexity of the filing. The SEC review process has not changed much as a result of the JOBS Act, although the issuer should anticipate that it will receive comments from the SEC staff regarding its EGC-related disclosures.

It is not unusual for the first SEC comment letter to contain a significant number of comments to which the issuer must respond both in a letter and by amending the registration statement. However, in recent years, there has been a general decline in the number of comments issued by the SEC staff, resulting in a shorter review process.

It is easy to anticipate many of the matters that the SEC will raise during the comment process. The SEC makes the comment letters and responses from prior reviews available on its website, so it is possible to determine the

most typical comments arising during the IPO process for similarly situated companies. Overall, the SEC staff looks for a balanced, clear presentation of the information required in the registration statement. Some of the most frequent comments raised by the SEC staff on disclosure, other than the financial statements, include:

Prospectus summary Is the presentation balanced? In the summary section, the SEC staff will expect to see a brief discussion that identifies that the issuer is an EGC and is electing to rely on certain accommodations available to EGCs.

Risk factors Are the risks specific to the company and devoid of mitigating language? The SEC also will expect to see certain risk factors relating to the issuer's status as an EGC.

Use of proceeds Is there a specific allocation of the proceeds among identified uses and, if funding acquisitions is a designated use, are acquisition plans identified?

Selected financial date Does the presentation of non-GAAP financial measures comply with SEC rules?

MD&A Does the discussion address known trends, events, commitments, demands, or uncertainties, including the impact of the economy, trends with respect to liquidity, and critical accounting estimates and policies?

Business Does the company provide support for statements about market position and other industry or comparative data? Is the disclosure free of, or does it explain, business jargon? Are the relationships with customers and suppliers, including concentration risk, clearly described?

Underwriting Is there sufficient disclosure about stabilisation activities (including naked short selling), as well as factors considered in early termination of lock-ups and any material relationships with the underwriters?

Exhibits Do any other contracts need to be filed based on disclosure in the prospectus?

After the SEC has provided its initial set of comments, it is much easier to determine when

the registration process is likely to be completed and the offering can be made. The company and counsel will prepare a complete and thorough response to the SEC staff's comments. In some instances, the company may not agree with an SEC staff comment and may choose to schedule calls to discuss the matter with the SEC staff. The company will file or confidentially submit an amendment revising the prospectus and provide the response letter along with any additional information. The SEC staff generally tries to address response letters and amendments within 10 days, but timing varies considerably. In most cases, the underwriters prefer to delay the offering process and to avoid distributing a preliminary prospectus until the SEC has reviewed at least the first filing and all material changes suggested by the SEC staff have been addressed by the company and its counsel in a responsive amendment.

Preparing the underwriting agreement, comfort letter and other documents

During the waiting period, the company, the underwriters and their counsel, and the company's independent auditor will negotiate a number of agreements and other documents, particularly the underwriting agreement and the auditor's comfort letter.

The underwriting agreement is the agreement pursuant to which the company agrees to sell, and the underwriters agree to buy, the shares and then sell them to the public; until this agreement is signed, the underwriters do not have an enforceable obligation to purchase the offered shares. The underwriting agreement is not signed until the offering is priced. In the typical IPO, the underwriters will have a 'firm commitment' to buy the shares once they sign the underwriting agreement.

Underwriting agreements have been revised to address JOBS Act changes. An underwriting

agreement for an EGC will contain representations and warranties by the EGC regarding its status as an EGC at each of the relevant times (when it made its confidential submission with the SEC, when it undertook any test-the-waters communications, on the date of execution of the underwriting agreement, and so on). The EGC will be asked to represent that it has not engaged in any test-the-waters communications other than with QIBs or IAs, and except as agreed with the underwriters. To the extent that it has distributed written test-the-waters materials, the EGC will be asked to make certain representations regarding the accuracy of those materials. Similarly, the EGC will be asked to make certain covenants to the underwriters, which will include an agreement to notify the underwriters if, at any time before the later of the time when a prospectus is required to be delivered in connection with the offering, and the completion of the lock-up period, the issuer no longer qualifies as an EGC. In addition, the lock-up language applicable to an EGC also will be revised to account for the quiet period changes included in the JOBS Act.

Underwriters' counsel will submit the underwriting agreement, the registration statement, and other offering documents for review to FINRA, which is responsible for reviewing the terms of the offering to ensure that they comply with FINRA requirements. An IPO cannot proceed until the underwriting arrangement terms have been approved by FINRA.

In the comfort letter, the auditor affirms its independence from the issuer and the compliance of the financial statements with applicable accounting requirements and SEC regulations. The auditor also will note period-to-period changes in certain financial items. These statements follow prescribed forms and are usually not the subject of significant negotiation. The underwriters will usually require that the auditor undertake certain agreed-upon procedures in which it compares

financial information in the prospectus (outside of the financial statements) to the issuer's accounting records to confirm its accuracy.

Marketing the offering

During the waiting period, marketing begins. Section 5(c) of the Securities Act prohibits offers of a security before a registration statement is filed. While gun-jumping can be a serious concern, the 2005 safe harbors created by Securities Offering Reform have provided considerable guidance to companies about this issue. Further, the ability to test-the-waters before filing, together with the elimination of the ban on general solicitation in connection with certain private placements effected by the JOBS Act, have also significantly reduced concerns about gun-jumping. In addition, the confidential submission of a draft registration does not constitute the filing of a registration statement for the purposes of the prohibition in Securities Act section 5(c) against making offers of a security in advance of filing a registration statement.⁴

Section 5(b)(1) prohibits written offers other than by means of a prospectus that meets the requirements of section 10 of the Securities Act, such as a preliminary prospectus. The only written sales materials that may be distributed during the waiting period are the preliminary prospectus, additional materials known as free writing prospectuses, which must satisfy specified SEC requirements, and any test-the-waters communications described above. The bans are designed to prohibit inappropriate marketing, conditioning or hyping of the security before all investors have access to publicly available information about the company so that they can make informed investment decisions.

From the first all-hands organizational meeting forward, all statements concerning the company should be reviewed by the company's

counsel to ensure compliance with applicable rules. While binding commitments cannot be made during this period, the underwriters will receive indications of interest from potential purchasers, indicating the price they would be willing to pay and the number of shares they would purchase. Once SEC comments are resolved, or it is clear that there are no material open issues, the issuer and underwriters will undertake a one- to two-week road show during which company management will meet with prospective investors. Except in the case of certain FPIs, the company, whether or not an EGC, must publicly file the confidentially submitted registration statement, along with any amendments, at least 15 days before the beginning of the road show.

Flipping from confidential to public

In a typical IPO, the issuer will continue to work with its counsel during the waiting period in order to address the SEC staff's comments on its filing, and also concurrently work on finalising various ancillary agreements, including the underwriting agreement and lock-up agreements. The underwriter and its counsel usually recommend that an issuer wait to finalize the underwriting agreement, and print a preliminary prospectus or red herring until the issuer and its counsel have responded to and addressed all of the significant comments raised by the SEC staff during the review process. This ensures that the issuer will not have to recirculate its preliminary prospectus as a result of any change arising during the review process. The underwriter will wait to commence the road show until the preliminary prospectus is prepared.

A company that is relying on the confidential submission process may want to consider when to make its first 'public' filing. As discussed in Chapter 1, and above, a company is required to file publicly with the

SEC at least 15 days before the commencement of the issuer's road show. The company may want to make a public filing before that for a variety of reasons, however. The company may want to file publicly earlier in the process, perhaps after it has undergone one or two amendments, in order to have it known to competitors or to strategic investors that the company is proceeding with an IPO and to make the registration statement available freely. This may be helpful if the issuer is contemplating a dual-track approach. It may be helpful in order to permit the underwriter to interest institutional investors in preliminary test-the-waters type discussions. Some institutional investors may be reluctant to commit the time and resources to meeting with a company or evaluating a potential investment if they believe that the offering is in a very preliminary stage. A company will want to consult with counsel and consider carefully its decision to transition from a confidential process to a public process. When the company files its first registration statement publicly, all previously submitted draft registration statements will become publicly available and all staff comment letters and issuer response letters will be posted on EDGAR.

Once SEC comments are cleared and the underwriters have assembled indications of interest for the offered securities, the company and its counsel will request that the SEC declare the registration statement effective at a certain date and time, usually after the close of business of the US securities markets on the date scheduled for pricing the offering.

The post-effective period

Once the registration statement has been declared effective and the offering has been priced, the issuer and the managing underwriters execute the underwriting agreement, and the auditor delivers the final

comfort letter. This occurs after pricing and before the opening of trading on the following day. The issuer then files a final prospectus with the SEC that contains the final offering information.

On the second or third business day following pricing, the closing occurs, the shares are issued, and the issuer receives the proceeds. The closing completes the offering process. Then, for the following 25 days, aftermarket sales of shares by dealers must be accompanied by the final prospectus or a notice with respect to its availability. If during this period there is a material change that would make the prospectus misleading, the issuer must file an amended prospectus.

Private offerings during the IPO process

An issuer may need to raise capital while it is pursuing an IPO. Historically, there was some concern about undertaking concurrent offerings. An issuer that had publicly filed a registration statement had to consider carefully with its counsel whether the public filing constituted a general solicitation that precluded the issuer from availing itself of the private placement exemption to complete a financing during the pendency of its IPO. For some time, practitioners relied on existing no-action letter guidance that was somewhat narrowly construed as permitting a concurrent private placement to QIBs and to a handful of IAIs.⁵ This fairly limited approach was modified over time and a more expansive view was expressed by the SEC first in 2007 and confirmed in Compliance and Disclosure Interpretations (C&DIs).⁶ The C&DI, confirming the guidance in the SEC's 2007 release, provides that:

Under appropriate circumstances, there can be a side-by-side private offering under Securities Act Section [4(a)(2)] or the Securities Act Rule 506 safe harbor with a registered public offering

*without having to limit the private offering to qualified institutional buyers and two or three additional large institutional accredited investors, as under the Black Box (June 26, 1990) and Squadron, Ellenoff (Feb. 28, 1992) no-action letters issued by the Division, or to a company's key officers and directors, as under our so-called "Macy's" position.*⁷

The SEC also clarified that a company can make a valid private placement if the investors are identified by means other than the registration statement.

Given this viewpoint, and even without considering the relaxation of the prohibition on general solicitation in respect of certain Rule 506 offerings, it is clear that an EGC could either, during the confidential phase or after the public filing of its registration statement, contact institutional investors and discuss a potential private financing. It is easy to envision that a test-the-waters conversation may morph into a discussion with an institutional investor about a potential private placement. An EGC should take care to be clear in its conversations with potential investors and ensure that any potential investors understand whether they are participating in a private placement transaction, and purchasing securities that will be restricted securities, and not expressing an interest in participating in the IPO.

The JOBS Act has contributed to a further blurring of the lines between private placements and public offerings given the relaxation of the prohibition against general solicitation and the introduction of exemptions for certain limited offerings pursuant to Regulation A and crowdfunding.

Foreign private issuers

Our discussions have focused on US domestic issuers; however, foreign issuers that are considering accessing the US capital markets will have available to them almost all of the

benefits of the JOBS Act. A foreign issuer must choose between undertaking a public offering in the United States, which would have the result of subjecting the issuer to ongoing securities reporting and disclosure requirements, and undertaking a limited offering that will not subject the issuer to US reporting obligations. A public offering in the United States offers distinct advantages for foreign issuers. The US public markets remain among the most active and deepest equity markets in the world. However, some foreign issuers may be discouraged by the regulatory burdens associated with being a US reporting company, including those imposed by the Sarbanes-Oxley and the Dodd-Frank Acts. For foreign issuers that qualify as EGCs, the IPO on-ramp process has made the United States more hospitable.⁸

An FPI is any issuer (other than a foreign government) incorporated or organized under the laws of a jurisdiction outside of the United States and either (1) has no more than 50% of its outstanding voting securities held directly or indirectly by residents of the United States, or (2) if more than 50% of the issuer's outstanding voting securities are held directly or indirectly by residents of the United States, then none of the following applies: (i) a majority of the issuer's executive officers or directors are US citizens or residents; (ii) more than 50% of the issuer's assets are located in the United States; or (iii) the issuer's business is principally administered in the United States.

An FPI may become subject to US securities law reporting requirements (1) by conducting a public offering in the United States by registering the offering and sale of its securities pursuant to the Securities Act, (2) by listing a class of its securities on a US national securities exchange through registration pursuant to the Exchange Act or (3) by becoming subject to the Exchange Act requirements if (a) the issuer has over \$10 million in assets as of the end of its fiscal year, (b) a class of its equity securities is held of record by 2,000 or more persons or 500 non-accredited

investors worldwide, and (c) the number of its US resident holders is 300 or more.

Important benefits are available to FPIs. For example, an FPI may exit or deregister its securities more easily than a domestic US issuer. An FPI must test its qualification only once a year, and, should it fail to qualify as an FPI, it has six months to transition to the US domestic reporting system. US domestic issuers generally must file their annual reports on Form 10-K within three months following the end of their fiscal year. By contrast, an FPI must file its annual report on Form 20-F within four months of the fiscal year covered by the report. This allows an FPI slightly more time to prepare the required information. An FPI has no legal obligation to file quarterly reports. By contrast, US domestic issuers must file a quarterly report on Form 10-Q. Unlike a US domestic issuer, an FPI has no legal obligation to file proxy solicitation materials on Schedule 14A or 14C in connection with annual or special meetings of its security holders. The securities exchanges generally provide alternative corporate governance requirements for listed FPIs by allowing them to follow its home-country governance practices (particularly with regard to audit committee and compensation committee requirements), which are less burdensome than those for listed US domestic issuers. An FPI is exempt from the SEC's disclosure rules for executive compensation on an individual basis but is required to provide certain information on an aggregate basis. An FPI may prepare its financial statements in accordance with IFRS as issued by the IASB without reconciliation to US GAAP. Like US companies, FPIs are subject to Sarbanes-Oxley requirements governing ICFR.

An FPI may submit its initial registration statement on a confidential basis to the SEC staff if it is a foreign government registering its debt securities, it is listed or is concurrently listing its securities on a non-US securities exchange, it is being privatized by a foreign

government, or it can demonstrate that the public filing of an initial registration statement would conflict with the law of an applicable foreign jurisdiction. An FPI may separately use the confidential registration statement review procedures available to US issuers.

An FPI can avail itself of the disclosure accommodations available under the JOBS Act if it elects to be treated as an EGC. An FPI can qualify to be treated as an EGC if it has total gross revenues of under \$1.07 billion (adjusted from \$1 billion in March 2017, and subject to inflationary adjustment by the SEC every five years) during its most recently completed fiscal year. Total gross revenues means total revenues as presented on the income statement under US GAAP or IFRS as issued by the IASB, if used as the basis of reporting by an FPI. If the financial statements of an FPI are presented in a currency other than US dollars, total gross revenues for purposes of determining whether an FPI is an EGC should be calculated in US dollars using the exchange rate as of the last day of the most recently completed fiscal year.

An FPI seeking to raise capital by selling securities (American Depositary Receipts or ADRs) in the United States must file a registration statement on Form F-1 with the SEC. The registration statement on Form F-1 requires significant disclosure about the FPI's business and operations, and is similar to, but less onerous than, the Form S-1 that most US issuers use for their IPOs. The SEC staff has made clear that an FPI that qualifies as an EGC and that is using a Form F-1 may avail itself of all of the disclosure accommodations available to domestic EGCs. An FPI that is an EGC also may avail itself of all other benefits available to domestic EGCs, including the governance related accommodations, the ability to test-the-waters, and the flexibility to have broker-dealers publish or distribute research reports about the company.

A foreign issuer also may decide to access the US capital markets through an exempt offering, such as an offering to QIBs or an offering made in reliance on section 4(a)(2) or

Rule 506. Offerings pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation provided that securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Offerings made pursuant to Rule 506(c) may use general solicitation provided that the securities are sold only to accredited investors and the issuer takes ‘reasonable steps’ to verify that all purchasers are accredited investors in connection with the offering. Issuers may also conduct private offerings without general solicitation pursuant to Rule 506(b).

Market trends relating to JOBS Act accommodations

Since the JOBS Act took effect on April 5 2012, there have been a number of trends in the IPO market. Companies electing EGC status come from many industries, although the largest groups of EGC IPO issuers are from the biotech/pharmaceuticals, technology, real estate, and healthcare industries. FPIs also are taking advantage of Title I of the JOBS Act. Standard disclosure has been developed by the IPO market regarding the election of EGC status and the chosen IPO on-ramp accommodations. In addition, there have been a number of trends with respect to the IPO on-ramp accommodations chosen by EGC issuers, which we describe in the pages that follow.

Confidential submissions

All issuers may submit its IPO registration statement confidentially in draft form for SEC staff review, provided that, with the exception of certain FPIs, the initial confidential submission and all amendments are publicly filed with the SEC within 15 days prior to the commencement of the road show. The confidential submission process permits an

EGC to commence the SEC review process without publicly disclosing sensitive strategic, proprietary, and financial information. In addition, in the case of adverse market conditions, weak investor demand in response to testing-the-waters communications, or regulatory concerns, an EGC may withdraw its draft registration statement and terminate the IPO process without ever making a public filing, thus removing a potential disincentive to commencing an IPO and permitting the immediate pursuit of a private placement or an M&A transaction instead.

The confidential submission process has been particularly popular among EGCs and has gained market acceptance. The vast majority of EGCs that priced an IPO since the JOBS Act took effect have confidentially submitted at least one draft registration statement prior to publicly filing and the majority of EGCs have submitted at least two draft registration statements prior to making their first public filing. Much of the discussion related to the confidential submission process has been focused on the timing of moving from the confidential submission to the first public filing, which is often based on having the 15-day period run in order to meet the IPO road show schedule and the desire to pursue a dual-track IPO and M&A strategy.

The confidential submission process appears thus far to be used primarily to keep the IPO process secret from competitors and the market without having to disclose sensitive strategic, proprietary, and financial information. However, not all companies have availed themselves of the confidential submission process. Some companies have forgone the process based on the belief that a public filing helps attract bidders in the case of a dual-track IPO and M&A strategy. However, a small number of companies engaged in a dual-track IPO and M&A strategy have, for strategic reasons, used the confidential submission process and publicly announced the confidential submission in a Securities Act Rule

135 compliant press release (in order to avoid gun-jumping).

Testing-the-waters communications and research coverage

Testing-the-waters communications and research practices continue to evolve. The decision of whether, when, and how to use testing-the-waters communications is being made on a case-by-case basis by EGC issuers and their underwriters. When testing-the-waters communications have been used, they have been used mainly for ‘meet the management’ presentations. With respect to research practices, although analysts employed by participating broker-dealers may publish research on EGCs earlier than currently allowed for non-EGCs, robust pre-deal research in connection with EGC IPOs has not emerged. In fact, most offering participants have been voluntarily restricting research publication for an agreed period following EGC IPOs (typically 25 days).

Reduced financial statements and selected financial data

Taking advantage of the scaled financial disclosures has gained some market acceptance, with more than half of all EGCs electing to provide only two years of audited financial statements rather than three years. The decision to take advantage of the scaled financial disclosures though is being made on a case-by-case basis, depending on whether the extra year of financial statements is needed to understand the EGC’s story (less important in the case of a biotechnology or development stage company) or show investors the EGC’s longer-term trends and historical growth trajectory (more important for a company with an operating history).

Extended transition for new or revised US GAAP accounting pronouncements

EGCs are not required to comply with new or revised US GAAP accounting pronouncements until those pronouncements apply to private companies, giving EGCs a longer transition than public companies in situations where a different effective date exists for a US GAAP accounting pronouncement specified for private companies. However, a significant majority of EGCs have not taken advantage of this extended transition period for compliance with new or revised GAAP accounting pronouncements because it might create an unfavourable comparison with competitors, and the EGC’s IPO registration statement must still satisfy the relevant Regulation S-X requirements.

Scaled executive compensation disclosures

EGCs are permitted to provide scaled executive compensation disclosure under the requirements generally available to smaller reporting companies. As a result, an EGC may: (1) omit the detailed CD&A; (2) provide compensation disclosure covering the top three (including the CEO), rather than the top five, executive officers for a period of two years as compared to three years; and (3) omit four of the six executive compensation tables required for larger companies. Over 70% of EGC IPO issuers from 2012 through 2019 that otherwise would have been required to include traditional executive compensation disclosures (*i.e.*, issuers other than FPIs, externally managed real estate investment trusts (or REITs), commodity pools, etc.) elected to take advantage of the reduced disclosure, with many omitting the CD&A section and including only a Summary Compensation Table and Outstanding Equity Awards Table covering three rather than five named executive officers and limiting the tabular disclosures to two years.

Exemption from auditor attestation report

EGCs are exempt from the requirements under Sarbanes-Oxley section 404(b) to have an auditor attest to the quality and reliability of the company's ICFR, and the exemption remains valid for so long as the company retains its EGC status.

In contrast, all other newly public companies, regardless of size, generally have until their second annual report to provide the auditor attestation report, and non-accelerated filers are permanently exempted. Most EGCs take advantage of (or reserve the right to do so in the future) the exemption from providing the auditor attestation report under Sarbanes-Oxley section 404(b).

In March 2020, the SEC adopted a rule that expanded this exemption to remove the requirement for an auditor to attest to the adequacy of ICFR for smaller reporting companies with revenues of less than \$100 million.⁹ This benefits low-revenue companies even if the funds raised in the public stock markets are not small. According to the SEC, the expanded exemption will affect 295 public companies, and one-third of the companies that will benefit from the expanded exemption are life science businesses, an industry with many early-stage drug developers that have yet to generate recurring revenue.

ENDNOTES

- 1 Under the Multi-Jurisdictional Disclosure System (MJDS), eligible Canadian issuers can file a registration statement on Form F-10 with the SEC that becomes effective immediately at the election of the Canadian issuer, generally without SEC review. The MJDS registration statement will include a prospectus prepared in accordance with Canadian form and content requirements.
- 2 See C&DI – Securities Act Forms (last updated Aug 17 2017), Question 101.04, available at <https://www.sec.gov/divisions/corpfin/guidance/safinterp.htm>.
- 3 Id. at Question 101.05.
- 4 SEC Confidential Submission FAQs, supra note 26, Question 6.
- 5 See, e.g., Division of Corporation Finance no-action letters to Black Box Incorporated (Jun 26 1990) and Squadron Ellenoff, Pleasant & Lehrer (Feb 28 1992).
- 6 The SEC’s integration guidance can be found in the Regulation D Proposing Release, Revisions of Limited Offering Exemptions in Regulation D, 33-8828 (Aug 3 2007), available at www.sec.gov/rules/proposed/2007/33-8828.pdf at pp. 52-56. See also C&DI – Securities Act sections (last updated Sep 22 2016), Question 139.25, available at <https://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm>.
- 7 See, e.g., C&DI – Securities Act sections (last updated Sep 22 2016), Question 139.25, available at <https://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm>.
- 8 Rule 3b-4(c) of the Exchange Act. An FPI is permitted to assess its status as an FPI once a year on the last business day of its second fiscal quarter, rather than on a continuous basis, and may avail itself of the FPI accommodations, including use of the FPI forms and reporting requirements, beginning on the determination date on which it establishes its eligibility as an FPI. If an FPI determines that it no longer qualifies as an FPI, it must comply with the reporting requirements and use the forms prescribed by US domestic companies beginning on the first day of the fiscal year following the determination date. SEC Release No. 33-8959. Note that if an FPI loses its status as an FPI it will be subject to the reporting requirements for a US domestic issuer, and while previous SEC filings do not have to be amended upon the loss of such status, all future filings would be required to comply with the requirements for a US domestic issuer. Financial Reporting Manual, Division of Corporation Finance, Topic 6120.2, available at www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml. Also note that if an FPI is reincorporated as a US entity, a registration statement on a domestic form (Form S-4) will be required for the exchange of shares with the new US domestic issuer. Id. at Topic 6120.8.
- 9 See SEC Press Release 2020-58, Fact Sheet available at <https://www.sec.gov/news/press-release/2020-58>.

CHAPTER 3

Applying Title I to other transactions

While Title I of the JOBS Act largely focuses on capital raising transactions, there is nothing in the JOBS Act or in the SEC's interpretations to suggest that the IPO on-ramp provisions in Title I should not also apply in the context of other transactions conducted by EGCs pursuant to a Securities Act registration statement. The SEC's Division of Corporation Finance has provided guidance in the form of FAQs indicating that EGCs may rely on certain of the disclosure, communications and confidential submission benefits for EGCs in the context of merger and exchange offer transactions.¹ An overriding principle of the guidance in these FAQs is that an EGC that avails itself of the Title I provisions in the context of an exchange offer or a merger must comply with all of the pre-existing applicable rules for tender offers and proxy solicitations, which might, in some cases, conflict with the more liberal communications approach contemplated by Title I of the JOBS Act. The SEC staff has also provided guidance regarding the EGC status of issuers that are spun off from SEC reporting issuers.

Availability of test-the-waters communications

As discussed in Chapter 1, Title I of the JOBS Act provides EGCs, or any other person authorized to act on their behalf, the flexibility to engage in oral or written communications with QIBs and IAIs in order to gauge their interest in a proposed offering, whether before or

following the first filing of any registration statement, subject to the requirement that no security may be sold unless accompanied or preceded by a prospectus.² In addition, and as discussed in Chapter 1, with the adoption of Rule 163B the SEC extended the ability to test-the-waters to all issuers. Neither the JOBS Act nor Rule 163B restricts such communications to those related to an IPO. There are no form or content restrictions on the communications, and there is no requirement to file written communications with the SEC (although the SEC staff requests that written communications be submitted to them when they review the related registration statement).

The SEC has confirmed that an EGC may use test-the-waters communications with QIBs and IAs pursuant to Securities Act section 5(d) in connection with an exchange offer or merger.³ In addition, the SEC staff notes that an EGC must make all required filings under the Exchange Act for any written communications made in connection with, or relating to, the exchange offer or merger. In this regard, the SEC staff notes that the JOBS Act did not amend the exchange offer or merger requirements under the Exchange Act, such as filings required under Exchange Act Rules 13e-4(c), 14a-12(b), and 14d-2(b), for pre-commencement tender offer communications and proxy soliciting materials in connection with a business combination transaction. Neither Rule 163B nor the SEC's adopting release directly addresses these issues for issuers who are not EGCs and cannot rely on section 5(d). However, Rule 163B(b)(1)'s broad use of the term 'registration statement' would seem to cover an exchange offer or merger related registration statement.

Confidential draft registration statement submissions

As discussed in Chapter 1, Title I added paragraph (e) to section 6 of the Securities Act to provide that the SEC must review all EGC IPO registration statements confidentially, if an

EGC chooses to submit a draft registration statement to the SEC. An EGC may confidentially submit a draft registration statement for an IPO for non-public review, provided that the initial confidential submission and all amendments are publicly filed with the SEC no later than 15 days (reduced from the original 21-day period) before the issuer's commencement of a road show).⁴

The SEC has indicated that an EGC may use the confidential submission process in section 6(e) of the Securities Act to submit a draft registration statement for an exchange offer or a merger that constitutes its IPO of common equity securities.⁵ If an EGC uses the confidential submission process to submit a draft registration statement for an exchange offer or merger that constitutes its IPO of common equity securities, the SEC notes a number of obligations under the Securities Act and the Exchange Act with respect to the transaction.

If an EGC does not commence its exchange offer before the effectiveness of the registration statement, the EGC must publicly file the registration statement (including the initial confidential submission and all amendments thereto) at least 15 days before either the earlier of the commencement date of the road show, if any, or the anticipated date of effectiveness of the registration statement. This applies in the case of all exchange offers that do not use early commencement, including those that do not qualify for early commencement under the provisions of Rules 13e-4(e)(2) and 14d-4(b) regarding going-private transactions and roll-up transactions.

An EGC that commences its exchange offer before effectiveness of the registration statement pursuant to Securities Act Rule 162 must publicly file the registration statement (including the initial confidential submission and all amendments thereto) at least 15 days before the earlier of: the commencement date of the road show, if any, or the anticipated date of effectiveness of the registration statement, but no later than the date of commencement of the

exchange offer in light of the filing requirement under Exchange Act Rules 13e-4(e)(2) and 14d-4(b).

For the early commencement of exchange offers subject only to Regulation 14E, an EGC must file its registration statement at least 15 days before the earlier of the commencement date of the road show, if any, or the anticipated date of effectiveness of the registration statement, but no later than the date of commencement of the exchange offer.

An EGC must also make the required filings under Securities Act Rule 425 (unless it is relying on the Securities Act section 5(d) provision for test-the-waters communications) and Exchange Act Rules 13e-4(c) and 14d-2(b) for pre-commencement tender offer communications. An EGC must also file the tender offer statement on Schedule TO on the date of commencement of the exchange offer under Exchange Act Rules 13e-4(b) and 14d-3(a), as applicable.

In a merger in which the target company is subject to Regulation 14A or 14C and the registration statement of the EGC acquirer includes a prospectus that also serves as the target issuer's proxy or information statement, the acquirer must publicly file the registration statement (including the initial confidential submission and all amendments thereto) at least 15 days before the earlier of the date of commencement of the road show, if any, or the anticipated date of effectiveness of the registration statement. In addition, the acquirer must make the required filings under Securities Act Rule 425 (unless it is relying on the Securities Act section 5(d) provision for test-the-waters communications) and Exchange Act Rule 14a-12(b) for any soliciting material, as applicable.⁶

Following the extension in June 2017 of the SEC staff's confidential review policy, the SEC will also accept draft registration statements submitted prior to the end of the twelfth month following the effective date of an issuer's initial Securities Act registration statement or an issuer's Exchange Act section 12(b) registration statement for nonpublic review.

Financial statement requirements

The SEC has stated that if a target company which does not qualify as a 'smaller reporting company' is to be acquired by an EGC that is not a shell company and will present only two years of its financial statements in its registration statement for the exchange offer or merger, the SEC will not object if, in the registration statement filed for the merger or exchange offer, the EGC presents only two years of financial statements for the target company.⁷

Spinoffs

The SEC has also addressed the EGC status of an issuer in the context of spinoffs and similar transactions. In circumstances where a public parent issuer decides to spin off a wholly-owned subsidiary, register an offer and sale of the wholly-owned subsidiary's common stock for an IPO, or transfer a business into a newly-formed subsidiary for purposes of undertaking an IPO of that subsidiary's common stock, the subsidiary would not necessarily trigger any of the disqualification provisions in sections 2(a)(19)(A)-(D) of the Securities Act, and would thus be considered an EGC if it had less than \$1.07 billion in revenues during its most recently completed fiscal year.⁸ This analysis focuses on whether the issuer, and not its parent, meets the EGC requirements. The SEC notes that, based on the particular facts and circumstances, the EGC status of an issuer under these circumstances may be questioned if it appears that the issuer or its parent is engaging in a transaction for the purpose of converting a non-EGC into an EGC, or for the purpose of obtaining the benefits of EGC status indirectly when it is not entitled to do so directly. The SEC recommends that issuers with questions relating to these issues should contact the Division of Corporation Finance's Office of the Chief Counsel.

ENDNOTES

- 1 Frequently Asked Questions of General Applicability on Title I of the JOBS Act (Apr 16 2012, May 3 2012, Sep 28 2012 and Dec 21 2015), available at www.sec.gov/divisions/corpfin/guidance/cfjjobstactfaq-title-i-general.htm (SEC Title I FAQs).
- 2 JOBS Act section 105(c), amending Securities Act section 5, 15 USC 77e.
- 3 SEC Title I FAQs, supra note 1 at Question 42.
- 4 For this purpose, the term ‘road show’ is defined in Securities Act Rule 433(h)(4).
- 5 SEC Title I FAQs, supra note 1 at Question 43.
- 6 SEC Title I FAQs, supra note 1 at Question 44.
- 7 SEC Title I FAQs, supra note 1 at Question 45.
- 8 SEC Title I FAQs, supra note 1 at Question 53.

CHAPTER 4

Private offerings

Title II of the JOBS Act directs the SEC to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 of Regulation D under the Securities Act, provided that the securities are sold only to accredited investors, and for offerings under Rule 144A under the Securities Act, provided that the securities are sold only to persons who the seller (or any person acting on the seller's behalf) reasonably believes is a QIB.

Rule 506 is the most popular means for conducting a private offering because it permits issuers to raise an unlimited amount of money and pre-empts state securities laws. In recognition of concerns about restrictions on communications in private offerings, Title II of the JOBS Act directs the SEC to revise Rule 506 to provide that the prohibition against general solicitation or general advertising in Rule 502(c) of Regulation D shall not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors, and to require that issuers using general solicitation or general advertising in connection with Rule 506 offerings take reasonable steps to verify that purchasers of securities are accredited investors, using methods to be determined by the SEC. Under the SEC's existing definition, an accredited investor is a person who falls within one of the categories specified in the definition, or a person who the issuer reasonably believes falls within one of those categories. With respect to Rule 144A, Title II of the JOBS Act directs the SEC to revise the rule to provide that securities may be offered to persons other than QIBs, including by means of general solicitation or

general advertising, provided that the securities are sold only to persons that the seller (or any person acting on the seller's behalf) reasonably believes is a QIB. The JOBS Act specifies that any offering made pursuant to the revised Rule 506 that uses general advertising or general solicitation will not be deemed a public offering.

Title II of the JOBS Act also specifies that persons who maintain certain online or other platforms to conduct Rule 506 offerings that will use general advertising or general solicitation will not, by virtue of this activity, be required to register as a broker or a dealer pursuant to Exchange Act section 15, provided that enumerated conditions are satisfied. In order to qualify for this exemption, such a platform must not receive transaction-based compensation, take possession of customer funds or securities, or be subject to an Exchange Act statutory disqualification.

On July 10 2013, the SEC adopted final rules (final rules) as directed by Title II of the JOBS Act to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 and offerings under Rule 144A. The final rules became effective September 23 2013.

Conditions for using Rule 506 of Regulation D, pre-JOBS Act

Rule 506(b) is considered a safe harbor for the private offering exemption of section 4(a)(2) of the Securities Act (section 4(a)(2)). Section 4(a)(2) exempts transactions by an issuer 'not involving a public offering' from the registration requirements of section 5 of the Securities Act. Rule 506 has proven to be an attractive means for conducting private offerings, because an issuer using it can raise an unlimited amount of money. The SEC observed that in 2012, Rule 506 was the most widely used Regulation D exemption, accounting for approximately 90 to 95% of all Regulation D filings that year.¹ Prior to the adoption of the SEC's final rules, the conditions for using Rule 506 were as follows:

- The issuer cannot use general solicitation or advertising to market the securities.
- The issuer may sell its securities to an unlimited number of accredited investors and up to 35 other purchasers. All non-accredited investors, either alone or with a purchaser representative, must be sophisticated: they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.
- An issuer must decide what information to give to accredited investors, so long as it does not violate the antifraud prohibitions of the federal securities laws, with non-accredited investors receiving disclosure documents that are generally the same as those used in registered offerings, and if the issuer provides information to accredited investors, it must make this information available to non-accredited investors as well.
- The issuer must be available to answer questions from prospective purchasers.
- Certain financial statement requirements to the extent that non-accredited investors are permitted to participate.
- Purchasers receive restricted securities.

As seen above, the availability of Rule 506 was conditioned, among other requirements, on the issuer or any person acting on its behalf, not offering or selling securities through any form of general solicitation or general advertising. Rule 502(c) of Regulation D provides some examples of general solicitation or general advertising, including advertisements, articles or notices published in any newspaper, magazine or similar media, or communications broadcast over television or radio, and seminars or meetings where attendees have been invited by general solicitation or general advertising. The SEC has stated that public or general advertising of an offering and general solicitation of investors are incompatible with a private placement exemption under section 4(a)(2).²

Issuers making use of the Rule 506 exemption do not have to file a registration statement with

the SEC, but they must file a Form D after they first sell their securities. Form D is a brief notice that includes the names and addresses of the issuer's owners and promoters and information concerning the offering.

For the purposes of Regulation D, an accredited investor includes:

- a bank, insurance company, registered investment company, business development company, or small business investment company;
- an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
- a charitable organization, corporation, or partnership with assets exceeding \$5 million;
- a director, executive officer, or general partner of the company selling the securities;
- a business in which all the equity owners are accredited investors;
- a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person;
- a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
- a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

Prior to the adoption of the SEC's final rules, Rule 506 did not include any bad actor limitations with respect to the issuer, its affiliates and offering participants. Bad actor disqualification provisions were mandated pursuant to section 926 of the Dodd-Frank Act. We describe the bad actor limitations adopted by the SEC in this chapter.

Conditions for using Rule 144A, pre-JOBS Act

Rule 144A is a safe harbor exemption from the registration requirements of section 5 of the Securities Act for certain offers and sales of qualifying securities by certain persons other than the issuer of the securities. Rule 144A is available only for resales of qualifying securities. Prior to the adoption of the SEC's final rules, the exemption applied to both reoffers and resales of securities to QIBs. This meant that, in order to avail oneself of the exemption, any offer of qualifying securities had to be made to an offeree that is a QIB. The securities eligible for resale under Rule 144A are securities of US and foreign issuers that are not listed on a US securities exchange or quoted on a US automated inter-dealer quotation system. Rule 144A also provides that reoffers and resales in compliance with the rule are not distributions and that the reseller is therefore not an underwriter within the meaning of section 2(a)(11) of the Securities Act. A reseller that is not the issuer, an underwriter, or a dealer can rely on the exemption provided by section 4(a)(1) of the Securities Act. Resellers that are dealers can rely on the exemption provided by section 4(a)(3) of the Securities Act.

SEC rulemaking under Title II of the JOBS Act

Discussion related to relaxing the ban on general solicitation had been going on since the early 1990s. Speeches and statements by SEC staff members over the years have commented on, and acknowledged, the need to revisit private placement exemptions in light of changes in communications patterns. The legal community has also given close consideration to these questions, going as far back as the late 1990s and early 2000s. In 2001, the American Bar Association's Committee on the Federal Regulation of Securities submitted a comment

letter to the SEC that suggested relaxation of the ban on general solicitation. At around the same time, the American Bar Association's Task Force for the Review of the Federal Securities Laws also proposed that a private offering would qualify for an exemption from registration based on the eligibility of the purchasers of the securities and the restrictions on resales, and not on the number of offerees. The Advisory Committee on Smaller Public Companies, formed in 2004, advocated a relaxation of the ban on general solicitation. In 2007, the SEC proposed a relaxation of the ban on general solicitation in the context of private offerings to a new category of large accredited investors.³

Final rules eliminating the prohibition against general solicitation and general advertising in Rule 506 and Rule 144A offerings

To implement Title II of the JOBS Act, the SEC amended Rule 506 by adding a new paragraph (c), under which the prohibition against general solicitation and general advertising would not apply. At the same time, the SEC retained the prior Rule 506 safe harbor as Rule 506(b), and thus, preserved the ability of issuers to conduct Rule 506 offerings subject to the prohibition of general solicitation in said Rule 506(b). The final rules eliminate the prohibition against general solicitation and general advertising contained in Rule 502(c) of Regulation D with respect to offers and sales of securities made pursuant to Rule 506(c), provided that all purchasers are accredited investors. Rule 506(c) also requires that for offerings involving the use of general solicitation, issuers take reasonable steps to verify that the purchasers of the securities are accredited investors. The SEC staff also has issued guidance in the form of C&DIs relating to the Rule 506(c) amendments.⁴

Eliminating the prohibition against general solicitation for Rule 506(c)

The SEC's final rules implement a bifurcated approach to Rule 506 offerings. An issuer may still choose to conduct a private offering without using general solicitation pursuant to Rule 506(b). On the other hand, under new Rule 506(c), general solicitation and general advertising are permitted so long as:

- The issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors.
- All purchasers of securities are accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors, at the time of the sale of the securities.
- The conditions of Rules 501 (definitions), 502(a) (integration), and 502(d) (resale restrictions) of Regulation D are satisfied.⁵

The SEC noted that the relaxation of the prohibition on general solicitation applies only to offerings made pursuant to the safe harbor provided by Rule 506(c), and it does not apply to offerings relying on the Securities Act section 4(a)(2) exemption in general.⁶ As a result, issuers relying on Rule 506(c) for their offerings will not be subject to the prohibition against general solicitation found in Rule 502(c). Issuers relying on Rule 506(b) or section 4(a)(2) will be subject to the prohibition against general solicitation found in Rule 502(c). The SEC stated that the use of general solicitation continues to be incompatible with a claim of exemption under section 4(a)(2).

The SEC also confirmed that the effect of section 201(b) of the JOBS Act is to permit privately offered funds (including private equity funds and hedge funds, among others) to make a general solicitation under amended Rule 506 without losing the ability to rely on the exclusions from the definition of an investment company available under section 3(c)(1) and 3(c)(7) of the

Investment Company Act of 1940, as amended (the Investment Company Act).⁷

Reasonable steps to verify accredited investor status under Rule 506(c)

The SEC indicated in the final rules that reasonable efforts to verify investor status will be a fact-based objective determination based on the SEC's prior principles-based guidance. New Rule 506(c) does not mandate any specific procedure that issuers must follow to be assured that the steps they have taken to verify that the purchasers of their securities are accredited investors are reasonable. In the adopting release, the SEC stated that "[w]hether the steps taken are "reasonable" will be an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction."⁸ The SEC noted that reasonable efforts to verify investor status may differ depending on the facts and circumstances, and the SEC indicated that it may be appropriate to consider the nature of the purchaser, the nature and amount of information about the purchaser, and the nature of the offering, as follows:

- **The nature of the purchaser** The SEC describes the different types of accredited investors, including broker-dealers, investment companies or business development companies, employee benefit plans, and wealthy individuals and charities.
- **The nature and amount of information about the purchaser** Simply put, the SEC states that "the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa."⁹
- **The nature of the offering** The nature of the offering may be relevant in determining the reasonableness of steps taken to verify status: issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through

a website accessible to the general public, or through the use of social media or email. By contrast, less intrusive verification steps may be required to the extent that solicitations are directed at investors that are pre-screened by a reliable third party.

The SEC stated that these factors are interconnected, and the more indicia that are in evidence that an investor qualifies as an accredited investor, the fewer steps the issuer must take to verify status. The SEC noted that issuers should retain adequate records to document the verification process.

In response to the concerns of many commenters on the proposed rules, in new Rule 506(c), the SEC added the four following specific non-exclusive methods of verifying accredited investor status for natural persons that will be deemed to meet the reasonable steps to verify requirement:

- a review of US Internal Revenue Service forms for the two most recent years and a written representation regarding the individual's expectation of attaining the necessary income level for the current year;
- a review of bank statements, brokerage statements, statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports by independent third parties in order to assess assets, and a consumer report or credit report from at least one nationwide consumer reporting agency in order to assess liabilities;
- a written confirmation from a registered broker-dealer, a registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps to verify that the person is an accredited investor within the prior three months and has determined that the person is an accredited investor; and
- with respect to any natural person who invested in an issuer's Rule 506(b) private placement as an accredited investor prior to the effective date of new Rule 506(c) and remains an investor of that issuer, for any Rule 506(c) offering conducted by the same issuer, an issuer can

obtain a certification from the person at the time of sale in the new offering that he or she qualifies as an accredited investor.¹⁰

As can be seen above, an issuer may verify that its investors are accredited by, among other ways, obtaining written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps within the prior three months to verify that the purchaser is an accredited investor and has determined that such purchaser is an accredited investor. The rationale behind this provision is that these third parties are all subject to various other regulatory, licensing, and examination requirements.

Because an issuer has the burden of demonstrating that its offering is entitled to an exemption from the Securities Act registration requirements, regardless of the steps an issuer takes to verify accredited investor status, the SEC stated that ‘it will be important for issuers and their verification service providers to retain adequate records regarding the steps taken to verify that a purchaser was an accredited investor.’¹¹

The SEC has received inquiries asking whether the SEC staff would provide guidance, presumably on a case-by-case basis, confirming that a specified principles-based verification method constitutes reasonable steps for purposes of Rule 506(c).¹² The SEC has indicated that the notion of the SEC staff reviewing and approving specific verification methods seems somewhat contrary to the very purpose of a principles-based rule and will not provide any additional guidance.¹³ Further, the SEC has expressed the view that this is an area where issuers and other market participants have the flexibility to think about innovative approaches for complying with the verification requirement of Rule 506(c) and use the methods that best suit their needs, and the SEC will not be quick to second-guess decisions that issuers and their advisers make in good faith that appear to be reasonable under the circumstances.¹⁴

Reasonable belief

The SEC confirmed the view that Congress did not intend to eliminate the existing reasonable belief standard in Rule 501(a) of Regulation D or for Rule 506 offerings. It confirmed that if a person were to supply false information to an issuer claiming status as an accredited investor, the issuer would not lose the ability to rely on the proposed Rule 506(c) exemption for that offering, provided the issuer ‘took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor’.¹⁵

Form D amendments

The SEC also amended Form D to add a separate check box for issuers to indicate whether they are claiming an exemption under Rule 506(c).¹⁶ Form D was also amended so that the check box for Rule 506 was renamed to Rule 506(b) so that issuers relying thereon can indicate whether they are claiming an exemption under Rule 506(b).

Eliminating the prohibition against general solicitation in Rule 144A; Final amendment to Rule 144A

As amended, Rule 144A(d)(1) only requires that securities sold in reliance on the rule be sold to a QIB, or to a person that the seller and any person acting on behalf of the seller reasonably believes is a QIB.¹⁷ The SEC also amended Rule 144A to eliminate references to offer and offeree;¹⁸ revised Rule 144A(d)(1) simply requires that securities must be sold – not *offered* and sold, as under the previous Rule 144A iteration. Hence, as amended, securities may be offered to persons other than QIBs, including by means of general solicitation or general advertising, provided that the securities are sold only to persons that the seller (or any person acting on the seller’s behalf) reasonably believes is a QIB. The SEC also noted

that the general solicitation now permitted by Rule 144A will not affect the availability of the section 4(a)(2) exemption or Regulation S for the initial sale of securities by the issuer to the initial purchaser.¹⁹

The SEC also clarified that for ongoing Rule 144A offerings that commenced before the effective date of the new rules, offering participants will be entitled to conduct the portion of the offering following the effective date of the new rules using a general solicitation, without affecting the availability of Rule 144A for the portion of the offering that occurred prior to the effective date.²⁰

Integration with offshore offerings

The SEC addressed the interplay between concurrent offerings made outside the US in reliance on Regulation S and inside the US made in reliance on Rule 506 or Rule 144A where there is a general solicitation or general advertising. Of particular concern is the requirement in Regulation S that there be no directed selling efforts in the US.

The SEC reaffirmed its position that an offshore offering conducted in compliance with Regulation S would not be integrated with a concurrent domestic unregistered offering that is conducted in compliance with Rule 506 or Rule 144A, even if there is a general solicitation or general advertising. This position is consistent with the SEC's views regarding integration of concurrent offshore offerings made in compliance with Regulation S and registered domestic offerings.

Disqualification of felons and other bad actors from Rule 506 offerings

On July 10 2013, the SEC also adopted amendments to rules promulgated under Regulation D to implement section 926 of the

Dodd-Frank Act.²¹ Section 926 of the Dodd-Frank Act requires the SEC to adopt rules that would make the Rule 506 exemption unavailable for any securities offering in which certain felons or other bad actors are involved. The amendments add bad actor disqualification requirements to Rule 506(d), which prohibit issuers and others, such as underwriters, placement agents, directors, executive officers, and certain shareholders of the issuer from participating in exempt securities offerings, if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws. The amendments were originally proposed on May 25 2011.²² In light of concerns raised by investor and consumer advocates that the relaxation of the prohibition against general solicitation in certain Rule 506 offerings would lead to an increased incidence of fraud, the SEC took action on the bad actor provisions at the same time as it promulgated the final Rule 506 amendments. These final rules (collectively, the bad actor rule) became effective on September 23 2013.

The new disqualification provisions apply to all Rule 506 offerings, regardless of whether general solicitation is used. The new provisions in Rule 506(d) and (e) generally track those in section 926 of the Dodd-Frank Act and Rule 262 of Regulation A under the Securities Act. Since the final rule became effective, the SEC staff has provided additional guidance on various interpretative matters in various series of C&DIAs as discussed below. Although it was anticipated that the relaxation of the prohibition against general solicitation in certain Rule 506 offerings and Rule 144A offerings would have a significant effect on the exempt offering market, at least in the short-term, the bad actor disqualification provisions have had a more immediate impact on offering practices. Issuers and financial intermediaries have had to establish policies and procedures and revise documentation in order to address these provisions.

Covered persons

The disqualification provisions in Rule 506(d)(1) apply to the following covered persons:

- the issuer and any predecessor of the issuer;
- any affiliated issuer;
- any director, executive officer, other officer participating in the offering, general partner, or managing member of the issuer;
- any beneficial owner of 20% or more of any class of the issuer's outstanding voting equity securities, calculated on the basis of voting power;
- any promoter (as defined in Rule 405) connected with the issuer in any capacity at the time of the sale;
- any investment manager of an issuer that is a pooled investment fund;
- any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities (a compensated solicitor);
- any general partner or managing member of any such investment manager or compensated solicitor; or
- any director, executive officer, or other officer participating in the offering of any such investment manager or compensated solicitor or general partner or managing member of such investment manager or compensated solicitor.²³

In the case of financial intermediaries likely to be involved in a private placement under Rule 506, rather than referring to underwriters, the rules apply to 'any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers (compensated solicitors)'.²⁴

Rule 506(d)(3) provides that the disqualification provisions do not apply to events relating to any affiliated issuer that occurred before the affiliation arose if the affiliated entity is not (i) in control of the issuer or (ii) under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events.

Two key changes from the categories of covered persons discussed in the proposing release are the inclusion in Rule 506(d)(1) of executive officers (*i.e.*, those performing policy-making functions) of the issuer and the compensated solicitor, instead of just officer, and a change to 20% from 10% shareholders of the issuer.

Disqualifying events

The final rule includes eight categories of disqualifying events. They are:

- criminal convictions;
- court injunctions and restraining orders;
- final orders (as defined in Rule 501(g) of Regulation D) of certain state regulators (such as securities, banking, and insurance) and federal regulators, including the US Commodity Futures Trading Commission (CFTC);
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
- certain SEC cease and desist orders;
- suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities SRO;
- SEC stop orders and orders suspending a Regulation A exemption; and
- US Postal Service false representation orders.²⁵

A discussion of each of these categories appears below.

Criminal convictions Rule 506(d)(1)(i) provides for disqualification of any covered person who has been convicted of any felony or misdemeanour in connection with the purchase or sale of any security, involving the making of any false filing with the SEC, or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities. The rule includes a five-year look-back period for criminal convictions of issuers, their predecessors, and affiliated issuers, and a ten-year

look-back period for other covered persons.²⁶

Court injunctions and restraining orders

Similar to Rule 262 of Regulation A, Rule 506(d)(1)(ii) disqualifies any covered person from relying on the exemption for a sale of securities if such covered person is subject to any order, judgment, or decree of any court of competent jurisdiction, entered within five years before such sale, that, at the time of such sale, restrains or enjoins such person from engaging in or continuing to engage in any conduct or practice (i) in connection with the purchase or sale of any security, (ii) involving the making of a false filing with the SEC, or (iii) arising out of the conduct of business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, or paid solicitor of purchasers of securities.²⁷

Final orders of certain regulators Final orders of regulatory agencies or authorities are covered by Rule 506(d)(1)(iii). That section disqualifies any covered person who is subject to a final order of: a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; the CFTC; or the National Credit Union Administration. The order must be final and:

(A) At the time of such sale, bar the person from:

- associating with an entity regulated by such commission, authority, agency, or officer;
- engaging in the business of securities, insurance, or banking; and
- engaging in savings association or credit union activities; or

(B) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years of such sale.

In a change from the proposing release, the rule also added CFTC final orders as disqualification triggers. In adding CFTC final orders, the SEC noted that the CFTC (rather

than the SEC) has authority over investment managers of pooled investment funds that invest in commodities and certain derivative products. The SEC reasoned that, absent adding CFTC final orders as a disqualifying trigger, regulatory sanctions against those investment managers would not likely trigger disqualification.²⁸

Final orders Rule 501(g) of Regulation D defines a ‘final order as a written directive or declaratory statement issued by a federal or state agency described in [Rule 506(d)(1)(iii)] under applicable statutory authority that provides for notice and an opportunity for a hearing, which constitutes a final disposition or action by that federal or state agency.’²⁹ The definition is based on the FINRA definition.

Fraudulent, manipulative, or deceptive conduct Rule 506(d)(1)(iii)(B) provides that disqualification must result from final orders of the relevant regulators that are ‘based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct’. Despite the suggestions of commenters, the SEC did not define ‘fraudulent, manipulative, or deceptive conduct’, did not exclude technical or administrative violations, and did not limit Rule 506(d)(1)(iii) to matters involving scienter.³⁰

SEC disciplinary orders Currently under Rule 262(b)(3), issuers and other covered persons that are subject to an SEC order entered pursuant to sections 15(b), 15B(a), or 15B(c) of the Exchange Act, or sections 203(e) or (f) of the Investment Advisers Act of 1940 (the Advisers Act), are disqualified from relying on the exemption available under Regulation A under the Securities Act. Under the cited provisions of the Exchange Act and the Advisers Act, the SEC has the authority to order a variety of sanctions against registered brokers, dealers, municipal securities dealers, and investment advisers, including the suspension or revocation of registration, censure, placing limits on their activities, imposing civil money penalties, and barring individuals from being associated with specified entities and from participating in the offering of any penny stock.

The SEC has historically required disqualification periods to run only for as long as an act is prohibited or required to be performed pursuant to an order. Therefore, censures are not disqualifying, and a disqualification based on a suspension or limitation of activities expires when the suspension or limitation expires.

Rule 506(d)(1)(iv) codifies this position but removes the reference to section 15B(a) of the Exchange Act. No look-back period was added to the rule.³¹

Certain SEC cease and desist orders

Although not required by section 926 of the Dodd-Frank Act, the SEC added an additional disqualification trigger, using its existing authority previously used to create bad actor provisions. Under Rule 506(d)(1)(v), an offering will be disqualified if any covered person is subject to any order of the SEC entered within five years before such sale that, at the time of such sale, orders the person to cease and desist from committing or causing a future violation of: (i) any scienter-based anti-fraud provision of the federal securities laws, including, without limitation, section 17(a)(1) of the Securities Act, section 10(b) of the Exchange Act and Rule 10b-5 thereunder and section 206(1) of the Advisers Act, or any other rule or regulation thereunder; or (ii) section 5 of the Securities Act. Note that the disqualification provision for section 5 of the Securities Act does not require scienter, which is consistent with the strict liability standard imposed by section 5.³²

Suspension or expulsion from SRO membership or association with an SRO member Rule 506(d)(1)(vi) disqualifies any covered person that is suspended or expelled from membership in, or suspended or barred from association with a member of, an SRO, for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade. This provision does not include a look-back period.³³

SEC stop orders and orders suspending the Regulation A exemption Rule 506(d)(1)(vii) imposes disqualification on an offering if a

covered person has filed (as a registrant or issuer), or was named as an underwriter in, any registration statement or Regulation A offering statement filed with the SEC that, within five years before such sale, was the subject of a refusal order, stop order, or order suspending the Regulation A exemption, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether a stop order or suspension order should be issued.³⁴

US Postal Service false representation orders The final disqualification provision is enumerated in Rule 506(d)(1)(viii), which disqualifies any covered person that is subject to a US Postal Service false representation order entered within five years preceding the sale of securities, or is, at the time of such sale, subject to a temporary restraining order or preliminary injunction with respect to conduct alleged by the US Postal Service to constitute a scheme or device for obtaining money or property through the mail by means of false representations.³⁵

Reasonable care exception

Rule 506(d)(2)(iv) creates a reasonable care exception that would apply if an issuer can establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person. The reasonable care exception helps preserve the intended benefits of Rule 506 and avoids creating an undue burden on capital-raising activities, while giving effect to the legislative intent to screen out felons and bad actors.³⁶

In order to rely on the reasonable care exception, the issuer would need to conduct a factual inquiry, the nature of which would depend on the facts and circumstances of the issuer and the other offering participants. In such an inquiry, an issuer would need to consider various factors, such as the risk that bad actors present, the presence of screening and other compliance mechanisms, the cost and burden of the inquiry,

whether other means used to obtain information about the covered persons is adequate, and whether investigating publicly available information is reasonable.³⁷

Transition issues

Although the look-back provisions of Rule 506(d) reach back to disqualifying events prior to the effectiveness of the rule, Rule 506(d)(2)(i) provides that disqualification will not arise as a result of triggering events that occurred prior to the date of the amendments. However, Rule 506(e) requires written disclosure to purchasers, at a reasonable time prior to the sale, of matters that would have triggered disqualification except that they occurred prior to September 23 2013, the rule's effective date. This disclosure requirement applies to all Rule 506 offerings, regardless of whether purchasers are accredited investors. Failure to make such disclosures will not be an 'insignificant deviation' within the meaning of Rule 508 of Regulation D; consequently, relief under that rule will not be available for such failure.³⁸

The SEC staff has provided additional guidance on the application of the rule through various C&DIs, including those issued on November 13 2013, December 4 2013, January 3 2014 and January 23 2014.³⁹

Other proposed amendments

In a separate proposing release issued in July 2013⁴⁰, the SEC proposed amendments to Form D and Rule 156 under the Securities Act. The Form D proposals included, among others, requiring: (i) the filing of a Form D in Rule 506(c) offerings before an issuer engages in general solicitation; (ii) the filing of a closing amendment to Form D after the termination of any Rule 506 offering; (iii) written general solicitation materials used in Rule 506(c) offerings to include certain legends and other

disclosures; and (iv) the submission, on a temporary basis, of written general solicitation materials used in Rule 506(c) offerings to the SEC; and disqualifying an issuer from relying on Rule 506 for one year if it did not comply within the last five years, with the Form D filing requirements. The proposed amendments to Rule 156 would extend the antifraud guidance contained in the rule (which currently applies only to registered funds) to the sales literature of private funds. Rule 156 prevents registered investment companies from using sales literature that is materially misleading in connection with the offer and sale of securities.

The SEC's proposed amendments, particularly the Form D amendments in the proposing release, were quite controversial and garnered significant opposition from businesses, members of Congress, lawyers, bar associations and trade associations, arguing that they were unnecessary, costly, burdensome and would impede capital formation. The comment period lapsed on November 4 2013 without the SEC taking further action. As of the date of this writing, the SEC has not re-introduced the proposing release and it appears unlikely that the SEC will seek similar amendments to Form D. The SEC has, however, recently proposed amendments under the Advisers Act relating to investment adviser advertisements, compensation for solicitations and Rule 156.⁴¹

Impact of Rule 506 amendments on broker-dealers, investment advisers, CPOs and CTAs

The amendments to Rule 506 affect issuers, as well as broker-dealers, investment advisers, commodity pool operators (CPOs), and commodity trading advisers (CTAs). Registered broker-dealers often act as intermediaries that facilitate Rule 506 offerings, while investment advisers (including CPOs and CTAs) organize and sponsor pooled investment funds that conduct Rule 506 offerings in an issuer capacity.

Broker-dealers, investment advisers, CPOs, and CTAs may be affected directly or indirectly by the amendments to Rule 506 in several ways, which we describe below.

Bad actor rule

SEC disciplinary orders relating to broker-dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons constitute disqualifying events under the bad actor rule. The scope of the bad actor rule has also been expanded by using the term investment manager rather than investment adviser. This is meant to ensure that control persons of pooled funds that deal in instruments other than securities, such as commodities, real estate, and certain derivatives, are covered persons and subject to disqualification under the bad actor rule. This revision recognized that, unlike operating companies making Rule 506 offerings, most pooled investment funds engaging in Rule 506 offerings function through their investment managers and their personnel and have few, if any, employees. Broker-dealers and other registered persons that participate in private placements will have to implement compliance policies and procedures in order to permit them to be in a position to represent to any issuers with which they are working on a Rule 506 offering that they are not 'bad actors'. In the aftermath of the financial crisis, a number of financial institutions were subject to governmental orders that are considered disqualifying events. These financial institutions have had to seek waivers from the SEC in order not to be disqualified from participating in private placements.

An issuer may rely on Rule 506's exemption even if there is a disqualification as to a covered person, such as a broker-dealer, if the issuer can demonstrate that it did not know and, in the exercise of reasonable care, it could not have known about the disqualification at the time of the sale of securities. Although issuers are generally required to exercise that reasonable care and

conduct associated factual inquiries themselves, when a registered broker-dealer acts as placement agent, it may be sufficient for the issuer to make inquiries concerning the relevant set of covered officers and controlling persons and to consult publicly available databases concerning the past disciplinary history of the relevant persons.

Use of general solicitation

Existing FINRA rules governing offering-related communications take on greater significance with the wider availability of general solicitation in private placements. This includes FINRA Rule 5123 (requiring FINRA members selling securities issued by non-members in certain private placements to file the private placement memorandum, term sheet, or other offering documents with FINRA within 15 days of the date of the first sale of securities) and FINRA Rule 2210 (establishing pre-approval, filing, content, and record retention requirements with respect to communications with retail investors). Furthermore, both broker-dealers and investment advisers participating in offerings made by issuers relying on Rule 506(c) will continue to be subject to FINRA and SEC rules generally prohibiting false or untrue statements. Broker-dealers participating in offerings made by issuers relying on Rule 506(c) would continue to be subject to FINRA rules regarding communications with the public, which, among other things: (1) generally require all member communications to be based on principles of fair dealing and good faith, to be fair and balanced, and to provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service; and (2) prohibit broker-dealers from making false, exaggerated, unwarranted, promissory, or misleading statements or claims in any communications. As a result, it may be difficult to advertise effectively while still complying with these FINRA rules. Concerns regarding these FINRA rules has led many broker-dealers to recommend against use of Rule 506(c) by their issuer clients.

Matchmaking sites

Matchmaking sites have come to play a more significant role in capital formation in recent years. A matchmaking site generally relies on the internet in order to match or introduce potential investors to companies that may be interested in raising capital. However, in order to avoid the requirement to register as a broker-dealer, a matchmaking site will limit the scope of its activities. Under section 3(a)(4) of the Exchange Act, a broker is defined as any person that is 'engaged in the business of effecting transactions in securities for the account of others'. The SEC has noted that a person 'effects transactions in securities if he or she participates in such transactions at key points in the chain of distribution', and that a person is engaged in the business if he or she receives transaction-related compensation, and holds him or herself out 'as a broker, as executing trades, or as assisting others in completing securities transactions'.⁴²

The determination as to whether an entity is acting as a broker is complex. The SEC closely considers many criteria and the specific facts and circumstances. Generally, though, the SEC has attributed great significance to whether the person receives transaction-based compensation. Given that acting as an unregistered broker-dealer would be met with serious consequences, many matchmaking sites sought further SEC guidance. Prior to the enactment of the JOBS Act, the SEC staff issued several no-action letters to matchmaking sites that sought relief from the requirement to register as broker-dealers. The no-action letter relief generally was conditioned on the requirement that the matchmaking site: (1) not provide any advice, endorsement, analysis, or recommendation about the merits of securities; (2) not receive compensation that is contingent on the outcome or completion of any securities transaction (transaction-based compensation); (3) not participate in any negotiations related to securities transactions; (4) not have any role in effecting securities trades; (5) not receive, transfer, or hold any investor funds or securities; and (6) not hold itself out as a broker-dealer.⁴³

Section 201(c) of the JOBS Act provides further legal certainty. Pursuant to this section, in the absence of other activities that would require registration, a matchmaking site is exempt from the requirement to register as a broker-dealer if, in connection with Rule 506 offerings: (1) it does not receive compensation based on the purchase or sale of securities; (2) it does not handle customer funds or securities; and (3) it is not a bad actor. A matchmaking site may maintain 'a platform or mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar or related activities by issuers of such securities, whether online, in person, or through any other means'.⁴⁴

A matchmaking site also may provide ancillary services in connection with Rule 506 offerings, which include 'due diligence services, in connection with the offer, sale, purchase, or negotiation of such security, so long as such services do not include, for separate compensation, investment advice or recommendations to issuers or investors'; and 'the provision of standardized documents to the issuers and investors, so long as such person or entity does not negotiate the terms of the issuance for, and on behalf of, third parties and issuers are not required to use the standardized documents as a condition of using the service'. This provision applies only to the activities of matchmaking sites in Rule 506 offerings.

Although many articles in the popular press refer to the use of the internet to offer securities in Rule 506 offerings to accredited investors as crowdfunding or accredited investor crowdfunding, it is important to note that the transactions taking place on such sites do not rely on the exemption under section 4(a)(6) of the Securities Act and Regulation Crowdfunding for crowdfunded offerings, and that the exemption from broker-dealer registration would not be available for crowdfunded offerings or for Regulation A offerings. Crowdfunded offerings must be conducted by either a registered broker-dealer or a registered funding portal.⁴⁵

In order to provide additional guidance relating to matchmaking sites, the SEC staff issued guidance in the form of frequently asked questions.⁴⁶ Also, in March 2013, the SEC's Division of Trading and Markets (the Division) provided the first no-action relief from registration as a broker-dealer after the issuance of the JOBS Act in a letter to FundersClub (FundersClub) and FundersClub Management.⁴⁷

In the letter, the SEC staff indicated that the Division would not recommend enforcement action under section 15(a)(1) of the Exchange Act if FundersClub and FundersClub Management operated a platform through which its members could participate in Rule 506 offerings. FundersClub identifies start-up companies in which its affiliated fund will invest, and then posts information about the start-up companies on its website so that the information is only available to FundersClub members, who are all accredited investors. FundersClub's members may submit non-binding indications of interest in an investment fund which relies on Rule 506 to conduct the offering. When a target level of capital is reached, the indication of interest process is closed, and FundersClub reconfirms investors' interest and accredited investor status and negotiates the final terms of the investment fund's investment in the start-up company. Members may withdraw their indications of interest at any time. In this process, FundersClub and FundersClub Management do not receive any compensation; however, some administrative fees are charged. FundersClub and FundersClub Management intend to be compensated through their role in organizing and managing the investment funds (at a rate of 20% or less of the profits of the investment fund, but never exceeding 30%). The SEC staff notes in the no-action letter that FundersClub's and FundersClub Management's current activities appear to comply with section 201 of the JOBS Act, in part because they and each person associated with them receive no compensation (or the promise of future compensation) in connection with the purchase or sale of securities. However, once FundersClub,

FundersClub Management, or persons associated with them receive compensation or the promise of future compensation, as described in their incoming letter, they will no longer be able to rely on section 201 of the JOBS Act. The SEC staff issued similar no-action relief to AngelList, another matchmaking site.⁴⁸

These letters are narrowly focused and do not address whether other registrations (such as registration as an investment adviser) would be required to be obtained. Also, the letters do not address or comment on any issues related to general solicitation or the means by which investors are identified or contacted. Given the popularity of matchmaking sites, an issuer may consider using such a service in connection with a proposed Rule 506 offering. The issuer and its counsel should familiarize itself with the business model and the operations of the matchmaking site. It will be essential for the issuer to understand whether the site is relying on the exemption under section 201 of the JOBS Act, or whether it is a registered broker-dealer, and the functions or services that the site will provide in connection with the financing. In addition, the issuer also will need to understand whether the activities of the site are organized in a manner that would constitute a general solicitation, requiring the issuer to rely on Rule 506(c) for its exemption and thereby triggering a need to conduct additional investor verification.

Guidance from the SEC staff on general solicitation and related issues

After the adoption of the final rules relaxing the prohibition against general solicitation for Rule 506(c) offerings, there was considerable debate regarding the types of communications that would constitute a general solicitation. For years, market participants had functioned without a precise definition for the term general solicitation. It was understood that the SEC would interpret the term broadly and that the term would

encompass communications relating to an offering of securities that were not directed at specific individuals or entities with which the issuer or a financial intermediary acting on the issuer's behalf had a pre-existing substantive relationship. Over the years, the staff of the SEC had provided guidance regarding the types of activities that were sufficient to establish a relationship prior to an offering of securities being made. In any event, many issuers and investors did not want to be deemed, by virtue of their communications, to be engaged in Rule 506(c) offerings, which would require that they undertake additional investor verification procedures. Also, many issuers were interested in using matchmaking platforms in order to assist them with Rule 506(b) offerings.

Perhaps as a result of these developments, the staff of the SEC's Division of Corporation Finance provided guidance in the form of a number of C&DIs that reaffirmed longstanding principles relating to the types of communications that would or would not be viewed as constituting a general solicitation.⁴⁹ The SEC staff clarified that communications that are directed to persons with whom the issuer or its agent has a pre-existing substantive relationship also would not be considered to be a general solicitation. Of course, by contrast, unrestricted communications relating to an offering made using the internet would constitute a general solicitation. The C&DIs also reiterate that regularly released factual business communications would not be considered a general solicitation. Persons other than registered broker-dealers and investment advisers can have a pre-existing relationship with a prospective offeree. Presentations at business plan competitions, demo days or venture fairs and the like should be evaluated and considered based on the facts and circumstances. If there is no mention made of a securities offering or the attendees are known to the issuer or confirmed to be sophisticated investors, one might conclude that there is no general solicitation.

Most matchmaking sites limit their advertising or solicitation activities, or primarily rely on Rule

506(b) offerings made to investors with whom they have a pre-existing substantive relationship. In order to ensure that their offerings are made in compliance with Rule 506(b), these sites generally rely on guidance issued by the SEC staff in various no-action letters, including the IPONet no-action letter issued to a broker-dealer and its affiliate.⁵⁰ Under the conditions described in IPONet, the SEC staff concluded that no general solicitation or advertising was involved because of the established principle that 'a general solicitation is not present when there is a pre-existing, substantive relationship between an issuer, or its broker-dealer, and the offerees.' The SEC staff considered the sufficiency of the qualification process implemented by a non-broker-dealer website operator that solicited investor interest in hedge funds in the no-action letter issued to Lamp Technologies Inc.⁵¹ Lamp imposed a 30-day waiting period from the time that an investor was first granted access to the restricted site and the first investment. The SEC staff noted that this was a satisfactory means of satisfying the no general solicitation requirement solely in the context of offerings of private hedge funds. The SEC interpretive guidance and the IPONet and Lamp no-action letters provide a roadmap for using internet-based communications in the context of an exempt offering of securities. In the above-mentioned C&DIs, the SEC staff reaffirmed this guidance and noted that the 30-day period may not be a hard and fast requirement. The SEC staff also issued a no-action letter in which it passed upon certain methods used by a platform-based sponsor in order to establish a substantive relationship with potential investors in venture capital funds.⁵² The no-action letter is significant in that it extends the prior guidance relating to reliance by an issuer on the pre-existing relationship formed by a broker-dealer with its clients to a registered investment adviser. Also, the no-action letter makes clear that in order to establish a pre-existing substantive relationship, a registered person or other intermediary must not only obtain information about a prospective investor's financial sophistication and status, but

it also must have the means to, and must, verify this information.⁵³

Concept release on harmonization of securities offering exemptions

On June 18 2019, the SEC issued a concept release soliciting ‘comment on possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections’.⁵⁴ The SEC observed that the overall framework for exempt offerings has changed significantly, due to the introduction, expansion or revision of various registration exemptions over the years, particularly since the adoption of the JOBS Act. The concept release does not contain specific rule proposals. Rather, the SEC seeks public comment on seven broad themes, as follows:

Exempt offering framework Whether the SEC’s exempt offering framework, as a whole, is consistent, accessible and effective for both companies and investors, or whether the SEC should consider changes to simplify, improve or harmonize the same.

Capital-raising exemptions within the framework Whether there should be any changes to improve, harmonize or streamline any of the capital-raising exemptions, including the private placement exemption and Rule 506, Regulation A and Rule 504.

Potential gaps in the framework Whether there may be gaps in the SEC’s framework that may make it difficult, especially for smaller companies, to rely on a registration exemption to raise capital at key stages of their business cycle.

Investor limitations Whether the limitations on who can invest in certain offerings or the amount they can invest, provide an appropriate level of investor protection or pose an undue obstacle to capital formation of investor access to investment opportunities.

Integration Whether the SEC can and should do more to allow companies to transition from

one exempt offering to another and ultimately to a registered public offering, if desired, without undue friction or delay.

Pooled investment funds Whether the SEC should take steps to facilitate capital formation in exempt offerings though pooled investment funds.

Secondary trading Whether the SEC should revise its rules governing exemptions for resales of securities to facilitate capital formation and to promote investor protection by improving secondary market liquidity.

The SEC identified 138 separate areas on which it is specifically asking for comment, and many of those areas contain multiple sub-requests for information.

With respect to Rule 506 offerings in particular, areas where the SEC is seeking input on this topic include whether:

- The SEC should consider any changes to Rule 506(b) or Rule 506(c), and whether the requirements under these rules appropriately address capital formation and investor protection considerations;
- Rules 506(b) and 506(c) should be combined into one exemption and, if so, what features of the existing rules should be retained;
- It is important to allow non-accredited investors to be able to participate in Rule 506(b) offerings;
- The information requirements of Rule 506(b) should be aligned with those of other exempt offerings or whether the SEC should consider eliminating or scaling such information requirements depending on the characteristics of non-accredited investors participating in the offering;
- The SEC should amend Regulation D to clarify or define general advertising and general solicitation;
- Investment limits should be added for non-accredited investors;
- The requirement to take reasonable steps to verify accredited investor status is having an impact on the willingness of issuers to use Rule 506(c);

- Non-accredited investors should be allowed to participate in an offering that involves general solicitation; and
- There are other changes to Rule 506 that the SEC should consider when harmonising the exempt offering rules.

The SEC is also seeking comment on whether any changes should be made to the accredited investor definition. Areas as to which the SEC is seeking input on this topic include whether:

- The current accredited investor definition should be retained;
- The financial thresholds should be adjusted;
- The definition of spouse should be expanded to include spousal equivalents; and
- Other measures of sophistication should be included that would allow a person to qualify as an accredited investor, for instance, permitting qualification based on certain professional credentials, relevant experience in exempt offerings or passing an accredited investor exam.

In addition, the SEC is seeking comment on whether revisions should be made to other aspects of the definition of accredited investor, including whether:

- Other entities should be eligible to qualify as accredited investors in addition to those enumerated in the existing rule; and
- The current \$5 million asset test should be replaced by an investments test.

As of the date of this writing, the SEC continues to receive a number of comment letters from different stakeholders with respect to the concept release, even though the official public comment period relating to the concept release closed on September 24 2019. On December 11 2019, the SEC also met with the Small Business Capital Formation Advisory Committee to discuss the concept release. In July 2020, the SEC released its Spring 2020 agenda, which included the concept release and accredited investor definition proposed amendments in the list of SEC proposals Chairman Clayton considered to be in the final stages of the rule-making process.

ENDNOTES

- 1 SEC Release No. 33-9414 (Jul 10 2013), available at www.sec.gov/rules/final/2013/33-9414.pdf at 5-6. The SEC also observed that for the 2009-2018 period, exempt offerings have accounted for significantly larger amounts of new capital compared to registered offerings during the same period, and that of the approximately \$2.9 trillion raised in 2018 for exempt offerings, about \$1.5 trillion relied on Rule 506(b) while \$211 billion relied on the new Rule 506(c). See SEC Release No. 33-10649 (Jun 18 2019), available at <https://www.sec.gov/rules/concept/2019/33-10649.pdf> at 17-19.
- 2 Non-Public Offering Exemption, Release No. 33-4552 (Nov 6 1962) 27 FR 11316 (Nov 16 1962). See also SEC Release Nos. 33-9415 (Jul 10 2013), available at www.sec.gov/rules/final/2013/33-9415.pdf at 12, and C&DIs, Securities Act Rules (updated Nov 13 2013), Question 260.13, available at <https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.
- 3 SEC Release No. 33-8828 (Aug 3 2007), available at www.sec.gov/rules/proposed/2007/33-8828.pdf.
- 4 See C&DIs—Securities Act Rules, available at www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.
- 5 SEC Release No. 33-9415 (Jul 10 2013), available at <https://www.sec.gov/rules/final/2013/33-9415.pdf>, at 20. The conditions of Rule 502(d) (“bad actor disqualifications”) of Regulation D must also be satisfied. See *infra* discussion under “Disqualification of felons and other bad actors from Rule 506 offerings.”
- 6 Id. at 12.
- 7 Id. at 47.
- 8 Id. at 20, 28-29.
- 9 Id. at 31.
- 10 Id. at 35.
- 11 Id. 28-29.
- 12 See speech of Keith F. Higgins, Director, Division of Corporation Finance, titled ‘Keynote Address at the 2014 Angel Capital Association Summit’ (Mar 28 2014), available at www.sec.gov/News/Speech/Detail/Speech/1370541320533#.U2PsBBnD-Hs.
- 13 Id.
- 14 Id.
- 15 Id. at 44.
- 16 Id. at 45.
- 17 Id. at 56.
- 18 Id. at 55.
- 29 Id.
- 20 Id. at 57.
- 21 SEC Release No. 33-9414 (Jul 10 2013), available at www.sec.gov/rules/final/2013/33-9414.pdf.
- 22 SEC Release No. 33-9211 (May 25 2011), available at www.sec.gov/rules/proposed/2011/33-9211.pdf.
- 23 *Supra* note 21, at 13.
- 24 Id. at 29.
- 25 Id. at 30.
- 26 Id. at 33.
- 27 Id. at 36.
- 28 Id. at 39.
- 29 Id. at 49.
- 30 Id.
- 31 Id. at 52.
- 32 Id. at 54.
- 33 Id. at 59.
- 34 Id. at 60.
- 35 Id. at 61.
- 36 Regulation D already has a provision, Rule 508, under which insignificant deviations from the terms, conditions, and requirements of Regulation D will not result in the loss of the exemption if the person relying on the exemption can show that: (i)

- the failure to comply did not pertain to a term, condition, or requirement directly intended to protect that individual or entity;
- (ii) the failure to comply was insignificant with respect to the offering as a whole; and
- (iii) a good faith and reasonable attempt was made to comply. The SEC does not believe that Rule 508 of Regulation D would cover circumstances in which an offering was disqualified under Rule 506(d).
- 37 *Supra* note 21, at 62.
- 38 *Id.* at 73.
- 39 *See* C&DIs—Securities Act Rules, available at www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.
- 40 SEC Release No. 33-9416 (Jul 10 2013), available at www.sec.gov/rules/proposed/2013/33-9416.pdf.
- 41 SEC Release No. IA-5407 (Nov 4 2019), available at www.sec.gov/rules/proposed/2019/ia-5407.pdf.
- 42 *See* SEC Denial of No-Action Request to Oil-N-Gas, Inc. (Jun 8 2000); SEC Denial of No-Action Request to Progressive Technology Inc. (Oct 11 2000); and SEC Denial of No-Action Request to 1st Global, Inc. (May 7 2001).
- 43 *See* Angel Capital Electronic Network, SEC No-Action Letter (Oct 25 1996); E-Media, LLC, SEC No-Action Letter (Dec 14 2000); Swiss American Securities, Inc. and Streetline, Inc., SEC No-Action Letter (May 28 2002); The Investment Archive, LLC, SEC No-Action Letter (May 14 2010); Roadshow Broadcast, LLC, SEC No-Action Letter (May 6 2011); and S3 Matching Technologies LP, SEC No-Action Letter (Jul 19 2012).
- 44 Section 201(c) of the JOBS Act; section 4(b)(1) of the Securities Act.
- 45 *See* SEC Release No. 33-9974 (Oct 30 2015), available at <https://www.sec.gov/rules/final/2015/33-9974.pdf>.
- 46 *See* Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act, available at www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm.
- 47 *See* FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter (Mar 26 2013).
- 48 *See* AngelList LLC, SEC No-Action Letter (Mar 28 2013).
- 49 *See* C&DIs—Securities Act Rules (updated Aug 6 2015), questions 256.23 to 256.32, available at www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.
- 50 *See* IPONet, SEC No-Action Letter (Jul 26 1996).
- 51 *See* Lamp Technologies, Inc., SEC No-Action Letter (May 29 1997).
- 52 *See* Citizen VC, Inc., SEC No-Action Letter (Aug 6 2015).
- 53 For more information regarding guidelines and considerations relating to general solicitation and general advertising when conducting Regulation D offerings, see Mayer Brown's On Point article "General Solicitation and General Advertising" available at <https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/08/on-point—general-solicitation.pdf>.
- 54 SEC Release No. 33-10649 (Jun 18 2019), available at <https://www.sec.gov/rules/concept/2019/33-10649.pdf>. *See also* SEC Press Release 2019-97, Fact Sheet available at <https://www.sec.gov/news/press-release/2019-97>.

CHAPTER 5

Crowdfunding

Title III of the JOBS Act addresses crowdfunding: an outgrowth of social media that provides a source of funding for a variety of ventures. Crowdfunding works based on the ability to pool money from individuals who have a common interest and are willing to provide small contributions for a venture. Given the difficulty in relying on then existing exemptions from registration for crowdfunding efforts involving the offer and sale of securities, Title III of the JOBS Act amended section 4(a) of the Securities Act to add a new paragraph (6), which provides for a new crowdfunding exemption from SEC registration (subject to rulemaking by the SEC), as well as pre-emption from state blue sky laws.

Crowdfunding can be used to accomplish a variety of goals (such as raising money for a charity or other causes of interest to the participants), but when the goal is of a commercial nature and there is an opportunity for crowdfunding participants to participate in the venture's profits, it is likely that federal and state securities laws will apply. Absent an exemption from registration with the SEC, or registering the offering with the SEC, crowdfunding efforts that involve the offer and sale of securities are, in all likelihood, in violation of section 5 of the Securities Act. In addition to SEC requirements, those seeking capital through crowdfunding need to be aware of state securities laws, which include varying requirements and exemptions. By crowdfunding through the internet, a person or venture can be exposed to potential liability at the US federal level in all 50 states, and potentially in foreign jurisdictions.

The exemptions that were available prior to the JOBS Act presented some problems for persons seeking to raise capital through crowdfunding. Regulation A requires a filing with the SEC and disclosure in the form of an offering circular, which would make conducting a crowdfunding offering expensive. The Regulation D exemptions generally would prove too cumbersome (with the possible exception of Rule 504), and a private offering approach or the intrastate offering exemption in Rule 147 and Rule 147A are inconsistent with widespread use of the internet for crowdfunding.

Title III of the JOBS Act

Title III of the JOBS Act addresses crowdfunding by providing an exemption from registration provided that:

- The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, is not more than \$1.07 million.
- The aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, does not exceed:
 - the greater of \$2,200 or 5% of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than \$107,000; or
 - 10% of the annual income or net worth of an investor, as applicable, not to exceed a maximum aggregate amount sold of \$107,000, if either the annual income or net worth of the investor is equal to or more than \$107,000.
- The transaction is conducted through a registered broker or funding portal that complies with the requirements of the exemption.
- The issuer complies with a number of specific informational and other requirements specified under the exemption.
 - All of the amounts above were adjusted for inflation by the SEC in April 2017.

Requirements for intermediaries

An exempt crowdfunding offering must be made through an intermediary that has registered with the SEC as a broker or as a so-called funding portal. Funding portals are not subject to registration as a broker-dealer but are subject to an alternative regulatory regime with oversight by the SEC and FINRA. A funding portal is defined as an intermediary for exempt crowdfunding offerings that does not:

- offer investment advice or recommendations;
- solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal;
- compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
- hold, manage, possess, or otherwise handle investor funds or securities; or
- engage in other activities as the SEC may determine by rulemaking.

A crowdfunding intermediary must provide specified disclosures to investors and take other steps related to the offering oriented toward investor protection, such as:

- ensuring that each investor:
 - reviews investor education information, in accordance with standards established by the SEC by rulemaking;
 - positively affirms that the investor understands that he or she is risking the loss of the entire investment and that the investor can bear such a loss; and
 - answers questions demonstrating: (i) an understanding of the level of risk applicable to investments in start-up companies; (ii) an understanding of the risk of illiquidity and (iii) an understanding of such other

matters as the SEC determines by rulemaking;

- taking measures, as established by the SEC by rulemaking, to reduce the risk of fraud including obtaining background and securities regulatory history check on insiders;
- furnishing the SEC with information presented to potential investors in a crowdfunding transaction;
- ensuring that all offering proceeds are only provided to issuers when the amount equals or exceeds the target offering amount and allowing for cancellation of commitments to purchase in the offering;
- ensuring that no investor in a 12-month period has invested in excess of the limit described above in all issuers conducting exempt crowdfunding offerings;
- taking steps to protect privacy of information;
- not compensating promoters, finders, or lead generators for providing personal identifying information of personal investors;
- prohibiting insiders from having any financial interest in an issuer using that intermediary's services; and
- meeting any other requirements that the SEC may prescribe.

Requirements for issuers

Issuers also must meet specific conditions in order to rely on the exemption, including making filings with the SEC and providing to investors and intermediaries information about the issuer (including financial statements, which need to be reviewed or audited depending on the target offering amount), its officers, directors, and greater than 20% of shareholders, and risks relating to the issuer and the offering, as well as specific offering information, such as the use of proceeds for the offering, the target amount for the offering, the deadline to reach the target offering amount, and regular updates regarding progress toward reaching the target. A crowdfunding issuer will also be subject to reporting requirements after the offering. Securities sold in

crowdfunding offerings are not 'restricted securities' as defined in Rule 144 of the Securities Act, but they are subject to transfer restrictions for one year following the sale.

The SEC's rules adopted under Title III also prohibit issuers from advertising the terms of the exempt offering, other than to provide notices directing investors to the funding portal or broker, and require disclosure of amounts paid to compensate solicitors promoting the offering through the channels of the broker or funding portal.

A purchaser in a crowdfunding offering can bring an action against an issuer for rescission in accordance with section 12(b) and section 13 of the Securities Act, as if liability were created under section 12(a)(2) of the Securities Act, in the event that there are material misstatements or omissions in connection with the offering.

The crowdfunding exemption is only available for domestic issuers that are not reporting companies under the Exchange Act and that are not investment companies, or as the SEC otherwise determines is appropriate. Bad actor disqualification provisions similar to those required under Regulation A are also applicable to crowdfunding offerings.

The Title III exemption pre-empts state securities laws by making exempt crowdfunding securities covered securities; however, some state enforcement authority and notice filing requirements are retained. State regulation of funding portals will also be pre-empted, subject to limited enforcement and examination authority.

Rulemaking activity

In October 2015, two years after the release of the proposed rules, the SEC adopted final crowdfunding rules, which became effective on May 16 2016. The SEC's Form Funding Portal became effective on January 29 2016 so that entities that seek to register as funding portals could begin the process. Below, we summarize the principal requirements of Regulation Crowdfunding. Rule references are to those under Regulation Crowdfunding.

Limit on capital raised

Consistent with the statutory limitations, Rule 100(a) provides that an issuer may sell up to \$1.07 million in any 12-month period to investors in an offering made pursuant to the exemption. Of course, an issuer may consider conducting other exempt offerings in close proximity with its crowdfunded offering. In calculating the amounts sold for purposes of the threshold, amounts sold by a predecessor or by an entity under common control with the issuer are aggregated with the amounts sold by the issuer.

Individual investment limits

Rule 100(a)(2) makes clear that the individual investor limit is an aggregate limit, which applies to all investments made by the individual over a 12-month period in crowdfunded offerings and not to a specific offering. An investor will be limited to investing:

- whichever is greater: \$2,200, or 5% of the lesser of the investor's annual income or net worth if either annual income or net worth is less than \$107,000; or
- 10% of the lesser of the investor's annual income or net worth, not to exceed an amount sold of \$107,000, if both annual income and net worth are \$107,000 or more.

As we discuss below, the issuer can rely on the intermediary's calculation of the investment limit; provided that the issuer does not have knowledge that the investor has exceeded, or would exceed, the investment limits as a result of participating in the issuer's offering.

Offering through an intermediary

An issuer is only able to engage in an offering through a registered broker-dealer or through a funding portal, and an issuer can only use one intermediary for a particular offering or concurrent offerings made in reliance on the

exemption. The offering must be conducted online only through the intermediary's platform so that the crowd has access to information, and there is a forum for an exchange of information among potential offering participants. A platform is defined as 'a program or application accessible via the internet or other similar electronic communication medium through which a registered broker or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on section 4(a)(6) of the Securities Act'.

Eligible issuers

The ability to engage in crowdfunding is not available to all issuers. By statute, the following issuers cannot rely on crowdfunding transactions under section 4(a)(6):

- issuers not organized under the laws of a state or territory of the US or the District of Columbia;
- issuers already subject to the Exchange Act's reporting requirements;
- investment companies as defined in the Investment Company Act or companies that are excluded from the definition of investment company under section 3(b) or 3(c) of the Investment Company Act; and
- any issuer that the SEC, by rule or regulation, determines appropriate.

Rule 100(b) also excludes:

- issuers disqualified from relying on section 4(a)(6) as a result of certain bad acts defined in Rule 503 under the Securities Act;
- issuers that have sold securities in reliance on section 4(a)(6) and have failed to make ongoing reports required by Regulation Crowdfunding during the two-year period immediately preceding the filing of the required offering statement; and
- any issuer that has no specific business plan or purpose, or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies.

Disclosure requirements

The statute sets out a number of required disclosures in any section 4(a)(6) offering. An issuer that elects to engage in a crowdfunding offering must comply with disclosure requirements, including: an initial disclosure about the offering on Form C, amendments to Form C to report material changes (Form C-A), periodic updates on the offering on Form C-U and ongoing annual filings until a filing obligation is terminated. The annual filing must be made on Form C-AR and a termination notice on Form C-TR.

Form C

Form C would be filed with the SEC, and the intermediary would post the filing or provide a link to the filing for investors. Form C must include disclosures relating to the issuer's business, officers, directors and control persons, use of proceeds, capital structure, and financial results, as discussed below in more detail. In many respects, the Form C requirements resemble those for Form 1-A used in connection with Regulation A offerings. The final Form C also includes an optional Q&A format that issuers may elect to use to provide certain disclosures.

Basic issuer information is required, including: the entity name, the form of entity, the jurisdiction of formation, formation date, address, website, number of employees, the issuer's website on which an investor can find the issuer's annual report, and the date by which such report will be made available, whether the issuer or any predecessor previously failed to comply with the ongoing reporting requirements of Regulation Crowdfunding. In addition, the form must disclose certain basic information about the intermediary, including: the intermediary's SEC file number and FINRA Central Registration Depository, or CRD, number and fees being paid to the intermediary, expressed either as a dollar amount or as a percentage of the offering amount, and a

description of the intermediary's financial interests in the transaction and in the issuer. In addition, the form requires a narrative discussion that addresses, among other things, the use of proceeds, the offering size, offering price, the issuer's business, a discussion of the issuer's results of operations, management and executive compensation, beneficial ownership, capital structure, related party transactions, and risks associated with an investment in the issuer's securities.

Financial statement requirements

Rule 201(t) provides some accommodations with respect to financial statement requirements depending upon the target offering size and for first-time issuers. Based on target offering size, the requirements (updated for inflation) are as follows:

- \$107,000 or less: the amount of total income, taxable income, and total tax or equivalent line items, as reported on the federal tax forms filed by the issuer for the most recently completed year (if any), certified by the principal executive officer of the issuer, and the financial statements of the issuer, also certified by the principal executive officer. If financial statements of the issuer are available that have either been reviewed or audited by a public accountant independent of the issuer, then these financial statements must be provided instead of the materials described in the preceding sentence.
- More than \$107,000 but not more than \$535,000: financial statements of the issuer reviewed by a public accountant independent of the issuer. If financial statements of the issuer are available that have been audited by a public accountant independent of the issuer, the issuer must provide those instead of the reviewed statements.
- More than \$535,000 and up to \$1.07 million: financial statements of the issuer audited by a public accountant independent of the issuer; provided, however, that for

issuers that have not previously sold securities pursuant to Title III, financial statements of the issuer may be reviewed by a public accountant independent of the issuer instead of audited. If audited statements are available, however, those must be provided instead.

Financial statements must be prepared in accordance with US GAAP. Audited financial statements must be conducted in accordance either with American Institute of Certified Public Accountants (AICPA) standards (referred to as US Generally Accepted Auditing Standards or GAAS) or PCAOB standards. The financial statements must cover the two most recently completed fiscal years or the period(s) since inception, if shorter. These requirements are similar to those applicable for Tier 1 offerings made under Regulation A. A signed audit report must accompany audited financial statements.

Other required filings

An issuer is required to amend its Form C disclosures using Form C/A for any updates or material changes. An issuer also is required to file progress updates with the SEC on a Form CU. An issuer that completes a crowdfunded offering must file with the SEC and post on its website an annual report on Form C-AR along with financial statements of the issuer certified by its principal executive officer within 120 days of the end of the issuer's fiscal year. The annual report is required to contain the same information required in the offering statement, as described above.

Termination of reporting

An issuer must file with the SEC a Form C-TR to terminate its reporting obligation within five days of the date on which it becomes eligible to do so. An issuer can terminate its ongoing reporting requirements upon the earliest to occur of the following:

- The issuer is required to file reports under the Exchange Act.
- The issuer has filed at least one annual report and has fewer than 300 holders of record.
- The issuer has filed at least three annual reports and has total assets that do not exceed \$10 million.
- The issuer or another party purchases or repurchases all of the securities issued pursuant to section 4(a)(6), including any payment in full of debt securities or any complete redemption of redeemable securities.
- The issuer liquidates or dissolves in accordance with state law.

Offering amount and offering mechanics

In connection with a proposed offering, Rule 201 requires that the issuer include in its disclosures a discussion of the target or maximum amount to be raised, and a discussion of the subscription or offering process. The description of the subscription process must disclose that investors can cancel their investment up to 48 hours prior to the deadline identified in the offering materials, but if an investor does not cancel the investment, then the investor's funds will be released to the issuer upon closing. The intermediary will notify investors when the target offering amount has been met, and if the target offering amount is not met, then no securities will be sold, and all funds will be returned to investors. If the target offering amount is met prior to the deadline identified in the offering materials, the issuer must provide five days' advance notice before closing the offering early. If an investor does not reconfirm the investment commitment after a material change is made to the offering and disclosed on Form C-A, the investment will be canceled, and the issuer must return the funds to the investor.

Types of securities offered

Regulation Crowdfunding does not limit the types of securities that may be offered in reliance on section 4(a)(6). An issuer may offer debt securities in a crowdfunded offering. An offering of debt securities is exempt from the requirement to qualify an indenture under the Trust Indenture Act of 1939, as amended (the Trust Indenture Act) because any offering exempted by section 4 of the Securities Act is exempt from the Trust Indenture Act's requirements.

Status of securities

Securities sold in a crowdfunded offering pursuant to the exemption are subject to transfer restrictions. Pursuant to Rule 501, securities issued in a crowdfunded offering cannot be transferred by a purchaser for one year from the date of purchase, except for transfers to: the issuer; an accredited investor; a family member of the purchaser or in estate-type transfers; and third parties in an SEC-registered offering. The statute exempts securities sold in section 4(a)(6) offerings from the Exchange Act holder of record count for the purposes of determining if registration of a class of equity securities is required under section 12(g) of the Exchange Act. An issuer will be required to establish a means for tracking its shareholders. This may require an early-stage company to engage the services of a transfer agent or other similar service provider in order to monitor its security holders.

Integration

An offering made pursuant to the section 4(a)(6) exemption will not be integrated with another exempt offering that precedes the crowdfunded offering or that takes place concurrently or subsequently. The issuer must ensure that it has satisfied all of the conditions for the exemption that it is claiming for each such offering. If the

issuer is conducting a Rule 506(c) offering (using general solicitation), it must ensure that the Rule 506(c) offerees were not solicited by means of the communications used for the crowdfunded offering.

Restrictions on advertising and promotion

Rule 204 limits the ability of the issuer, as well as the ability of others acting on the issuer's behalf, to advertise. Rule 204 sets out the information that may be included in an offering notice. The adopting release notes that this notice is intended to be similar to tombstone ads permitted under Securities Act Rule 134. The issuer may communicate with potential crowdfunding investors if the communications occur through the platform; however, it should be clear to potential investors on which platform communications are being made by the issuer or on the issuer's behalf. Regulation Crowdfunding does not limit an issuer from continuing to engage in regular business communications so long as the issuer does not disclose information about the offering, except as permitted in an offering notice. However, Regulation Crowdfunding does not contain an express safe harbor for regularly released business information.

Promoter compensation

Rule 205 prohibits an issuer from compensating, or committing to compensate, directly or indirectly, a person for advertising or promoting a section 4(a)(6) offering through the intermediary's platform, unless the issuer takes reasonable steps to ensure that the person clearly discloses the receipt (past and prospective) of compensation each time that such person makes a promotional communication. A founder or employee of the issuer that engages in promotional activities on the issuer's behalf through the intermediary's platform is required to

disclose in each posting that he or she is engaging in those activities on the issuer's behalf.

Intermediaries

Title III of the JOBS Act provides that a crowd-funded offering must be made through an intermediary that is either a registered broker-dealer or a funding portal. The intermediary is intended to function as a gatekeeper and, in this role, protect investors from fraud. Regulation Crowdfunding establishes a regulatory framework for these intermediaries. As discussed below, in the case of funding portals, the regulatory framework is a scaled back version of the framework applicable to broker-dealers. We discuss the applicable rules in the sequence of an offering and then provide an overview of the registration, compliance, and other requirements applicable to intermediaries.

Conducting a crowd-funded offering

As discussed above, Rule 100 requires that an offering be made only through one intermediary.

Financial interests in issuer

Rule 300 prohibits directors, officers, or partners (or others having a similar status or performing a similar function) of an intermediary from having any financial interest in an issuer using its services and prohibits such persons from receiving a financial interest in an issuer as compensation for the service provided to or for the benefit of the issuer in connection with the offering. An intermediary cannot have a financial interest in an issuer that is using the intermediary's platform, unless:

- The intermediary receives the financial interest from the issuer as offering compensation.

- The financial interest consists of securities of the same class and having the same terms as those sold in the offering.

The SEC has clarified that a warrant to purchase a share of common stock will not be considered 'securities of the same class' when shares of common stock are being sold in the offering.

A financial interest in an issuer means a direct or indirect ownership of, or economic interest in, any class of the issuer's securities.

Measures to reduce risk of fraud

Under Rule 301, an intermediary must have a reasonable basis to believe that the issuer is in compliance with relevant regulations and has an established means to keep accurate records of holders of the securities it offers. An intermediary may reasonably rely on the issuer's representations, absent knowledge or other information that suggests that the representations are not true. The specific steps an intermediary should take to determine whether it can rely on an issuer's representation may vary but should be influenced by and tailored according to the intermediary's knowledge and comfort with each particular issuer. In addition, when an intermediary seeks to rely on representations to form a reasonable basis, it should have policies and procedures regarding the circumstances under which it can reasonably rely on such representations and when additional investigative steps may be appropriate.

An intermediary must deny access to an issuer if it has a reasonable belief that the issuer or its offering would present a potential for fraud. An intermediary is required to deny access to its platform to an issuer if the intermediary has a reasonable belief that the issuer, or any of its directors, officers or 20% of its beneficial owners is subject to a disqualification under Rule 503. An intermediary must conduct a background and securities enforcement regulatory history check on each issuer whose securities are to be offered

by the intermediary, as well as on each of its officers, directors (or any person occupying a similar status or performing a similar function), and 20% of its beneficial owners.

Account opening

Under Rule 302, no intermediary or associated person may accept an investment commitment until the investor opens an account with the intermediary and the intermediary obtains consent for the electronic delivery of materials. An intermediary is required to deliver certain information to each investor, including educational materials, by electronic message, with links to information posted on the intermediary's website.

Educational materials

Rule 302 requires that, in connection with establishing an account, an intermediary deliver educational materials in plain English. Any revised materials must be made available to all investors before accepting any additional investment commitments or effecting any further crowdfunded transactions. The rule sets out the topics that must be addressed in the educational materials. An intermediary is also required to inform investors that disclosure is required regarding any past or prospective compensation paid to a promoter. An intermediary also must disclose the compensation it will receive in connection with crowdfunded offerings.

Issuer information

Under Rule 303, an intermediary must make available to the SEC and potential investors, not later than 21 days prior to the first day on which securities are sold to any investor, any information provided by the issuer under Rules 201 and 203(a). The information must be made publicly

available on the intermediary's platform in a manner that reasonably permits a person accessing the platform to save, download, or store the information; this information must be made publicly available on the intermediary's platform for a minimum of 21 days before any securities are sold in the offering, during which time the intermediary may accept investment commitments; and this information, including any additional information provided by the issuer, must remain publicly available on the intermediary's platform until the offer and sale is completed or canceled. An intermediary cannot require any person to establish an account with the intermediary in order to receive this information.

Investor qualifications

Securities Act section 4A(a)(8) imposes an obligation on intermediaries to make sure no investor exceeds the statutory investment limitations. Rule 303 implements this requirement by providing that, before permitting an investor to make an investment commitment on its platform, an intermediary must have a reasonable basis to believe that the investor satisfies the investment limitations discussed above. Rule 303 allows reasonable reliance on an investor's representation to this effect.

Investor's acknowledgment of risks

Securities Act section 4A(a)(4) requires an intermediary to ensure that each investor reviews the educational materials, positively affirms that the investor understands that he or she is risking the loss of the entire investment and that the investor could bear such a loss, and answer questions demonstrating an understanding of the level of risk involved in startups. As discussed above, educational materials must be provided at the account opening. Rule 303 requires that an intermediary, each time before accepting an

investment commitment, obtain from the investor a representation that the investor has reviewed the intermediary's educational materials and understands that the entire investment may be lost, and can bear the risk of loss. The intermediary also must ensure, each time before accepting an investment commitment, that each investor answers questions demonstrating their understanding that there are restrictions on the investor's ability to cancel an investment commitment and obtain a return of his or her investment, that it may be difficult for the investor to resell the securities, and that the investor should not invest any funds in a crowdfunding offering unless he or she can afford to lose his or her investment in its entirety.

Communication channels

Rule 303 requires an intermediary to provide, on its platform, channels through which investors can communicate with one another and with representatives of the issuer about offerings made available on the intermediary's platform, subject to certain conditions. This is intended to provide a centralized and transparent means for members of the public to share their views and to communicate with the issuer. The intermediary cannot participate in the communications; however, the intermediary can set rules regarding the postings or remove postings that use offensive language. Communications should be available for public viewing, but the intermediary is only able to permit those persons who have opened accounts with it to post comments. With each post, a person must disclose whether such person is a promoter or affiliate of the issuer and whether it has been or will be compensated. The intermediary must keep records of these communications.

Notice of investment commitment

An intermediary, upon receipt of an investment commitment from an investor, must promptly

give or send to the investor a notification disclosing: the dollar amount of the commitment, the price of the securities (if known), the name of the issuer, and the date and time by which the investor may cancel the investment commitment. Notification must be provided by email or other electronic media and be documented in accordance with applicable recordkeeping rules.

Maintenance and transmission of funds

Securities Act section 4A(a)(7) requires that an intermediary 'ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount'. An intermediary that is a registered broker must comply with established requirements under Exchange Act Rule 15c2-4 for the maintenance and transmission of investor funds. Investor funds must be held in escrow until the specified contingency occurs (*i.e.*, the targeted amount or the minimum amount is raised) and then the funds would be promptly transmitted to a bank, which has agreed in writing to hold such funds in escrow for the investors and to transmit or return such funds directly to the issuer or to investors, as the case may be. Proceeds are to be transmitted to the issuer only if the target offering amount is met or exceeded.

Because a funding portal cannot receive or handle any funds, it is required to direct investors to transmit money or other considerations directly to a qualified third party (a registered broker-dealer, a bank, or a credit union) that serves as an escrow agent. A funding portal must promptly direct transmission of funds from the qualified third party to the issuer when the aggregate amount of investment commitments from all investors is equal to or greater than the target amount of the offering and the cancellation period for each investor has expired, but no earlier than 21 days after the date on which the intermediary makes publicly available on its platform the

information required to be provided about the issuer and the offering. A funding portal must direct the return of funds to an investor when an investment commitment has been canceled or the offering is terminated or canceled.

Confirmation of transaction

At or before the completion of a transaction, the intermediary is required to give or send each investor a notification, similar to a confirmation, disclosing: the transaction date, the type of security, the price and number of securities purchased, the number of securities sold by the issuer in the transaction, the price at which the securities were sold, certain specified terms of the security (for example, if it is a debt or callable security), and the source and amount of any remuneration received or to be received by the intermediary in connection with the transaction, whether from the issuer or other persons. This notification must be by email or other electronic media and subject to recordkeeping rules.

Completion of offerings, cancellations and reconfirmations

Investors have an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the deadline identified in the issuer's offering materials. Thereafter, an investor cannot cancel any investment commitments made within the final 48 hours (except in the event of a material change to the offering, as discussed below).

If an issuer reaches the target offering amount prior to the deadline identified in its offering materials, it may close the offering once the target offering amount is reached, provided that: the offering will have remained open for a minimum of 21 days; the intermediary provides notice about the new offering deadline at least five business days prior to the new offering deadline; investors are given the opportunity to reconsider their investment decision and to cancel their

investment commitment until 48 hours prior to the new offering deadline; and at the time of the new offering deadline, the issuer continues to meet or exceed the target offering amount.

If there is a material change to the terms of the offering or the information provided by the issuer regarding the offering, the intermediary must give or send notice of the material change to any potential investors who have made investment commitments. This must state that the investment commitment will be canceled unless the investor reconfirms his or her commitment within five business days of receipt of the notice. If the investor fails to reconfirm his or her investment within those five business days, the intermediary, within five business days thereafter, must provide or send the investor a notification disclosing that the investment commitment was canceled, the reason for the cancellation, and the refund amount that the investor should expect to receive, and direct the refund of investor funds.

Finally, if an issuer does not complete an offering because the target is not reached or the issuer decides to terminate the offering, the intermediary, within five business days, must give or send to each investor who made an investment commitment a notification disclosing: the cancellation of the offering, the reason for the cancellation, and the refund amount that the investor should expect to receive. It must also direct the refund of investor funds and prevent investors from making investment commitments with respect to that offering on its platform.

Intermediary registration and other requirements

An intermediary must be registered as a broker-dealer with the SEC under section 15(b) of the Exchange Act or a funding portal registered with the SEC in accordance with the requirements of Rule 400. It must also be a member of a national securities association registered under section 15A of the Exchange Act, which is FINRA.

Additional requirements on funding portals

The SEC has established a streamlined registration process under which a funding portal registers with the SEC by filing a form, Form Funding Portal, with information consistent with, but less extensive than, the information required for broker-dealers on Form BD. A funding portal registers by completing a Form Funding Portal, which includes information concerning: the funding portal's principal place of business, legal organization, and disciplinary history, if any; business activities, including the types of compensation the funding portal has received and disclosure of its disciplinary history, if any; FINRA membership with any other registered national securities association; and the funding portal's website address(es) or other means of access. A funding portal's registration becomes effective the later of: (1) 30 calendar days after the date that the registration is received by the SEC; or (2) the date the funding portal is approved for membership in FINRA. In order to promote transparency, all such Forms Funding Portal will be available publicly.

Non-US funding portals

Entities domiciled or organized outside of the US (non-resident funding portals) are able to act as funding portals; however, they are subject to additional requirements. There must be an information-sharing arrangement in place between the SEC and the competent regulator in the jurisdiction under the laws of which the non-resident funding portal is organized, or where it has its principal place of business. In addition, a non-resident funding portal is required to have an agent for service of process in the US, as well as an opinion of counsel addressing the ability of the applicant to provide the SEC and any national securities association of which it is a member with prompt access to its books and records, and to submit to onsite inspection and examination by

the SEC and the relevant national securities association. The non-resident funding portal also is required to consent that service of any civil action brought by, or notice of any proceeding before, the SEC or any national securities association of which it is a member, in connection with the funding portal's investment-related business, may be given by registered or certified mail to the non-resident funding portal's contact person at the main address or mailing address indicated on the form.

Exemptions from broker-dealer registration and safe harbors

But for the exemption from registration for funding portals that Congress directed in the JOBS Act, a funding portal would be required to register as a broker under the Exchange Act. Rule 401(a) exempts an intermediary that is registered as a funding portal from the requirement to register as a broker-dealer under the Exchange Act, although a funding portal remains subject to the full range of the SEC's examination and enforcement authority. Under Rule 402(a), a funding portal cannot:

- offer investment advice or recommendations;
- solicit purchases, sales, or offers to buy the securities displayed on its platform; or
- compensate employees, agents, other persons for such solicitations based on the sale of securities displayed or referenced on its platform; or hold, manage, possess, or otherwise handle investor funds or securities.

In addition, Rule 402(b) sets out certain permitted activities of a funding portal, such as: providing a channel for investors to communicate about an offering, highlighting particular offerings made through its funding portal based on objective criteria, advising issuers on the offering structure, paying for referrals subject to certain conditions, entering into arrangements with broker-dealers (including compensation arrangements), and limiting the offerings made through its platforms based on particular criteria

without risk of being deemed to provide investment advice.

The SEC has stated that it does not believe a funding portal should be permitted to physically meet with investors to solicit investments or offerings on its platform or host launch parties because those activities likely violate the statutory prohibition on funding portals soliciting and providing investment advice and recommendations.

Compliance policies and procedures

A funding portal is required to implement written policies and procedures designed to achieve compliance with applicable regulations. A funding portal will be required to comply with the same privacy rules (Regulation S-P, Regulation S-AM, and Regulation S-ID) applicable to broker-dealers. A funding portal is subject to the SEC's examination and inspection authority. Also, a funding portal is subject to recordkeeping requirements in order to ensure that there is an audit trail for all crowdfunding transactions and communications.

Bad actor provisions

Rule 503 sets out bad actor disqualification provisions. The section 4(a)(6) exemption is not available for a sale of securities if the issuer, a predecessor of the issuer, an affiliated issuer, any director, officer, general partner or managing member of the issuer, a beneficial owner of 20% or more of the issuer's outstanding voting equity securities, any promoter or solicitor, or any general partner, director, officer, or managing member of any such solicitor is subject to a statutory disqualification.

FINRA rules

As discussed above, intermediaries must be registered with FINRA. Final FINRA rules (Rules

100, 110, 200, 300, 800, 900, and 1200), referred to as the Funding Portal Rules, became effective January 29 2016. The rules reflect an attempt to streamline regulatory requirements in light of the limited scope of activities of a funding portal while maintaining investor protection provisions. The FINRA rules are summarized below.

- Rule 100 provides that funding portals and their associated persons are subject to FINRA's bylaws.
- Rule 110 outlines the membership application process (MAP). FINRA must make a decision on membership within 60 days of the filing of a membership application (Form FP-NMA). Rule 110 establishes standards for membership, including: (a) ability to comply with all applicable laws and regulations of the SEC and FINRA; (b) contractual arrangements sufficient to initiate operations; (c) supervisory systems that are sufficient; (d) evidence of direct and indirect funding; and (e) a recordkeeping system. Rule 110 permits membership interviews to take place by video, streamlines the appeals process, and narrows the events involving a change of control of the member that require FINRA approval.
- Rule 200 requires funding portals to observe high standards of commercial honour and just and equitable principles of trade. Rule 200(b) prohibits a portal from effecting any transaction in, or inducing the purchase or sale of, any security by means of, or by aiding or abetting, any manipulative or fraudulent device. Rule 200(c) tracks FINRA Rule 2210 on advertising and requires that funding portal communications be fair and balanced and prohibits the use of false and misleading statements and statements that predict future performance.
- Rule 300 requires funding portals to establish and maintain written policies and procedures and supervisory systems reasonably designed to achieve compliance with all applicable rules. Rule 300 also requires disclosure of certain events to FINRA within 30 days after a

member knows or should have known that the event occurred. These events include the funding portal member being named as a defendant in certain litigations or regulatory proceedings and being denied registration, expelled from or otherwise being disciplined by a securities-related regulatory body.

- Rule 800 provides that information about funding portals and associated persons provided to FINRA, including information about disqualifying events, will be made public.
- Rule 900 addresses codes of procedure, including the process for eligibility proceedings for a person to remain associated with a portal despite the existence of a statutory disqualification.
- Rule 1200 addresses arbitration procedures for customer and industry disputes.

Appendix A INTERMEDIARY COMPARISON

	Broker-dealer	Funding portal
Regulatory environment	Well-established SEC and FINRA rules regarding registration and ongoing obligations.	New SEC and FINRA rules regarding registration and ongoing obligations.
Conduct of business	Handling customer funds and securities, making investment recommendations, compensated for sales of securities, etc.	Restrictions on activities traditionally considered to be those activities characteristic of broker-dealer status.
Costs	Significant registration costs, as well as ongoing compliance costs. A broker-dealer may receive transaction-based compensation.	Less burdensome ongoing obligations, thus lower costs involved. Funding portal cannot receive transaction-based compensation.
Availability of crowdfunding exemption	Available for issuers using broker-dealer's platform.	Available for issuers using funding portal's platform.

CHAPTER 6

Regulation A+

As we discuss in Chapter 4, in order to raise capital, most issuers rely on exemptions from registration adopted pursuant to section 4 of the Securities Act. There are, however, a number of other exemptions from registration that may be available to issuers. Section 3(b) of the Securities Act authorizes the SEC to adopt rules and regulations exempting securities from registration if the SEC finds that registration ‘is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering’. One of the exemptions that the SEC adopted pursuant to section 3(b) of the Securities Act is Regulation A.¹ Historically, pursuant to Regulation A, issuers that were not SEC-reporting companies were able to raise up to \$5 million in offering proceeds through sales of their securities in interstate offerings without complying with the registration requirements of the Securities Act.² Regulation A also provided controlling stockholders, as well as non-affiliates, an opportunity to sell their unregistered securities. A Regulation A offering is not a private offering; in fact, a Regulation A offering is often referred to as a mini-registration. Regulation A incorporated a number of conditions that in certain respects resembled the registration requirements of section 5 of the Securities Act. For example, in order for an issuer to avail itself of the exemption, it must: prepare and file an offering statement for the SEC’s review and approval, deliver the offering statement to prospective investors, and file periodic reports of sales after completion of the offering.

The requirements for the offering statement were not as onerous as those applicable to a section 10 prospectus. However, due to the low offering threshold, and without a corresponding state blue sky exemption for securities offered in Regulation A offerings, prior to the enactment of the JOBS Act, Regulation A did not offer a viable capital-raising approach. Rule 506 of Regulation D, which has no offering threshold, became the most commonly used exemption from registration.

Regulation A reform has been considered a number of times over the course of the last few years. Title IV of the JOBS Act, titled Small Company Capital Formation, amends section 3(b) of the Securities Act, increasing the dollar threshold for a Regulation A-style offering, but did not actually amend Regulation A. Instead, as discussed below, in March 2015 the SEC adopted new rules that amended Regulation A and since that time has continued to make minor changes to Regulation A.

History of Regulation A and Regulation A reform

Regulation A was enacted during the Great Depression to promote capital formation for small businesses. One of the SEC's primary purposes in adopting Regulation A was to provide a simple and efficient process by which small businesses could raise limited amounts of capital, while ensuring that investors had access to current information. When originally enacted, section 3(b) authorized the SEC to exempt only small issues involving offerings of \$100,000 or less. Over time, this dollar threshold was adjusted. In 1980, the small issue exemption was increased by Congress to \$5 million.³ The SEC did not actually increase the threshold until 1992, however.⁴

In July 1992, the SEC adopted a number of small business-related initiatives that included significant amendments to Regulation A.⁵ These changes were intended to facilitate 'access to the

public market for start-up and developing companies and...[to reduce] the costs for small businesses to undertake to have their securities traded in the public markets'.⁶ The amendments increased the threshold amount to \$5 million in any 12-month period, including no more than \$1.5 million in non-issuer resales. The availability of Regulation A was conditioned upon meeting certain substantive and procedural requirements.⁷

There had been various efforts to amend Regulation A. Commentators noted that, while over the years the offering threshold had been increased to \$5 million, the dollar amount had not kept pace with changes related to capital formation. In 2009, the recommendation to raise the dollar threshold made it into the final report of the SEC's Government-Business Forum on Small Business Capital Formation.⁸ Increasing the Regulation A dollar threshold was also discussed.⁹

Statistics demonstrated that the offering threshold of Regulation A was too low and did not align with market realities.¹⁰ In connection with a hearing before the House Committee on Financial Services in December 2010, regarding increasing the Regulation A offering threshold from \$5 million to \$30 million, William R Hambrecht, Chairman and CEO of WR Hambrecht + Co, stated that, 'according to public records, since 2005 there have only been 153 Regulation A filings and of those 153, an astoundingly low number of 13 have actually priced.'¹¹ Following the financial crisis, concerns about the availability of capital for smaller, emerging companies intensified, which led, in March 2011, to the introduction of legislation that would have increased the Regulation A offering threshold, titled the Small Company Capital Formation Act.¹² In introducing the proposed legislation, Congressman Schweikert, Vice-Chairman of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, said: 'Taking a small business public is an important but expensive process that requires millions in underwriting costs...raising the Regulation A threshold to \$50 million is one way to lower those costs and promote economic

growth and job creation. At a time when so many small businesses are in need of capital, this is a common sense proposal that will make our capital markets more vibrant and competitive.¹³

As discussed in the introduction, the Small Company Capital Formation Act was part of a broader effort to address US job creation and economic competitiveness and to amend or repeal certain sections of the Dodd-Frank Act.¹⁴ Industry representatives testified in support of the proposed Regulation A reform,¹⁵ as exemplified by testimony from David Weild, then a senior adviser of Grant Thornton, who provided an analysis of the devastating decline in numbers of small IPOs, demonstrating that small businesses and entrepreneurs could not access the capital they needed to grow and create jobs.¹⁶ The legislation was met with strong bipartisan support. Ultimately, the changes that were contemplated in these bills were incorporated into the JOBS Act, albeit with some modifications.

It is important to note that, throughout the preceding few years, when commentators were considering amending Regulation A to increase the dollar threshold and address state blue sky matters, the proposals had as their underlying premise that smaller issuers that were not SEC-reporting companies would be able to conduct one or more Regulation A offerings and elect either to remain non-reporting issuers, or voluntarily seek to have their securities listed and quoted on a national securities exchange (thereby becoming SEC-reporting companies) and use Regulation A as an alternative to a traditional IPO. The notion of an IPO on-ramp, or scaled approach to IPOs for EGCs, had not yet been proposed.

Title IV of the JOBS Act

Section 401 of the JOBS Act amends section 3(b) of the Securities Act by adopting a new section (b). Pursuant to the as amended section 3(b)(2), the SEC is authorized to promulgate rules or

regulations creating an exemption that is substantially similar to the existing Regulation A. Under this exemption an issuer is able to offer and sell up to \$50 million in securities within a 12-month period in reliance on the exemption.¹⁷ The issuer may offer equity securities, debt securities, and debt securities convertible or exchangeable for equity interests, including any guarantees of such securities. The securities sold pursuant to the exemption may be offered and sold publicly (without restrictions on the use of general solicitation or general advertising) and are not considered restricted securities. The issuer may test-the-waters or solicit interest in the offering before filing any offering statement with the SEC, subject to any additional conditions or requirements that may be imposed by the SEC. The civil liability provision in section 12(a)(2) of the Securities Act applies to any person offering or selling such securities.

The securities will be considered covered securities for purposes of the National Securities Market Improvement Act of 1996 (NSMIA), and not subject to state securities review, if: the securities are offered and sold on a national securities exchange; or the securities are offered or sold to a qualified purchaser as defined under the Securities Act.¹⁸ These provisions are more limited than those originally contained in the standalone Regulation A legislation. During consideration of the Regulation A legislation, it became clear that perhaps the only significant source of controversy regarding modernising Regulation A related to state blue sky qualification. State securities regulators, through the North American Securities Administrators Association (NASAA), expressed concerns about the potential for fraud and abuse related to offerings for small companies, including offerings completed pursuant to Regulation A. NASAA opposed certain aspects of the proposals to modernize the regulation of these offerings that would involve broader state blue sky pre-emption.¹⁹

The statute requires that the issuer file audited financial statements with the SEC annually. The SEC may impose other terms, conditions, or

requirements deemed necessary for investor protection, including a requirement that the issuer prepare and file electronically with the SEC and distribute to prospective investors an offering statement and any related documents, including a description of the issuer's business and financial condition, its corporate governance principles, the intended uses of proceeds, and other appropriate matters. The SEC may also require an issuer that relies on the exemption to make available to investors and file with the SEC periodic disclosures. The bad actor disqualification provisions applicable for the exemption shall be substantially similar to the disqualification provisions contained in the regulations adopted pursuant to section 926 of the Dodd-Frank Act (which looks to the bad actor disqualification provisions in historical Regulation A).

Not later than two years after enactment and every two years thereafter, the SEC shall review the offering threshold and report to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate on its reasons for not increasing the dollar amount.

Required study on blue sky laws

Section 402 of the JOBS Act requires that the Comptroller General conduct a study of the impact of state blue sky laws on offerings made under Regulation A. Within three months of enactment of the JOBS Act, the Comptroller General must deliver the report to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate. The study titled *Factors that May Affect Trends in Regulation A Offerings* was delivered in July 2012.²⁰ The study notes that there are a number of factors that contributed to the lack of utility of the Regulation A exemption, and highlighted the time and expense associated with state blue sky compliance. The study concluded that without

pre-emption of the state blue sky requirements, Regulation D would continue to be used in favour of Regulation A.

Final rules

In March 2015, the SEC voted unanimously to adopt final rules to implement the rulemaking mandate of Title IV of the JOBS Act by adopting amendments to Regulation A. The final rules provide an exemption for US and Canadian companies that are not required to file reports under the Exchange Act to raise up to \$50 million in a 12-month period. The final rules create two tiers: Tier 1 for smaller offerings raising up to \$20 million in any 12-month period; and Tier 2 for offerings raising up to \$50 million. The rules also make the exemption available, subject to additional limitations on the amount, for the sale of securities by existing stockholders. The rules modernize the existing framework under Regulation A by, among other things, requiring that disclosure documents be filed on EDGAR, allowing an issuer to make a confidential submission with the SEC, permitting certain test-the-waters communications, and disqualifying bad actors. The final rules impose different disclosure requirements for Tier 1 and Tier 2 offerings, with more disclosure required for Tier 2 offerings, including audited financial statements. Tier 1 offerings will be subject to both SEC and state blue sky pre-sale review. Tier 2 offerings are subject to SEC, but not state blue sky, pre-sale review; however, investors in Tier 2 offerings are subject to investment limits (except when securities are sold to accredited investors or are listed on a national securities exchange) and Tier 2 issuers are required to comply with periodic filing requirements, which include a requirement to file current reports upon the occurrence of certain events, semi-annual reports and annual reports. The final rules also provide a means for an issuer in a Tier 2 offering to concurrently list a class of securities on a national exchange through a

short-form Form 8-A, without requiring the filing of a separate registration statement on Form 10. The final rules became effective on June 19 2015.

Eligible issuers

Regulation A is available to issuers organized in and having their principal place of business in the US or Canada. Certain issuers are ineligible to offer or sell securities under Regulation A, including: a development stage company that either has no specific business plan or purpose or has indicated that its business plan is to merge with or acquire an unidentified company; any investment company registered or required to be registered under the Investment Company Act (this includes business development companies); any business development company; and any entity issuing fractional undivided interests in oil or gas rights, or similar interests in other mineral rights. The exemption also is not available to: issuers that have not filed with the SEC the ongoing reports required by Regulation A during the two years immediately preceding the filing of a new offering statement; issuers that have had their registration revoked pursuant to an Exchange Act section 12(j) order that was entered into within five years before the filing of the offering statement; and certain bad actors.

In January 2019, amendments to Regulation A made the exemption available to issuers that are subject to the Exchange Act reporting requirements.

Eligible securities

The securities that may be offered under Regulation A are limited to equity securities including warrants, debt securities, and debt securities convertible into or exchangeable into equity interests, including any guarantees of such securities. Rule 261(c) excludes asset-backed securities.

Offering limitations

As noted above, an issuer can choose a Tier 1 or a Tier 2 offering. Under Tier 1, an issuer may offer and sell up to \$20 million in a 12-month period, of which up to \$6 million may constitute secondary sales (except as noted below). Under Tier 2, an issuer may offer and sell up to \$50 million in a 12-month period, of which up to \$15 million may constitute secondary sales (except as noted below). In the issuer's initial Regulation A offering and any subsequent Regulation A offering in the following 12 months, the selling securityholder component cannot exceed 30% of the aggregate offering. In addition, the final rules distinguish between sales by affiliates and sales by non-affiliates. Following the expiration of the first year following an issuer's initial qualification of a Regulation A offering statement, the limit on secondary sales falls away for non-affiliates only.

Investment limitation

To address potential investor protection concerns, Rule 251(d)(2)(i)(C) imposes an investment limit for Tier 2 offerings. The investment limit does not apply to accredited investors and does not apply if the securities are to be listed on a national securities exchange at the consummation of the offering; otherwise a non-accredited natural person is subject to an investment limit and must limit purchases to no more than 10% of the greater of the investor's annual income and net worth, determined as provided in Rule 501 of Regulation D (for non-accredited, non-natural persons, the 10% limit is based on annual revenues and net assets).

Integration of offerings

A Regulation A offering will not be integrated with (1) prior offers or sales of securities, or (2) subsequent offers or sales of securities that are: registered under the Securities Act, except as

provided in Rule 255(e); made in reliance on Rule 701; made pursuant to an employee benefit plan; made in reliance on Regulation S; made pursuant to section 4(a)(6) of the Securities Act (*i.e.*, crowdfunding offerings); or made more than six months after the completion of the Regulation A offering. Rule 255 addresses abandoned offerings in much the same way that these are handled by Rule 155, with a 30-day cooling off period. The SEC also reaffirmed guidance that was included in the proposing release, which is consistent with the guidance regarding integration provided in SEC Release No. 33-8828 (August 3 2007).

Exchange Act threshold

The final rule provides a limited exemption for securities issued in a Tier 2 offering from the section 12(g) holder of record threshold where the issuer is subject to, and current in its, Regulation A periodic reporting obligations. In order to benefit from this conditional exemption, an issuer must retain the services of a transfer agent and meet specific requirements (public float of less than \$75 million or, in the absence of a public float, revenues of less than \$50 million, in the most recently completed fiscal year). An issuer that exceeds the section 12(g) threshold will have a two-year transition period.

Filing and delivery requirements

Regulation A offering statements must be filed on EDGAR. Form 1-A has been amended to consist of three parts: Part I, which is an XML-based fillable form with basic issuer information; Part II, which is a text file that contains the disclosure document and financial statements; and Part III, which is a text file that contains exhibits and related materials. Periodic reports and any other documents required to be submitted to the SEC in connection with a Regulation A offering must be filed on EDGAR. Rule 251 includes an access equals delivery model for Regulation A final

offering statements. In the case where a preliminary offering statement is used to offer securities to potential investors and the issuer is not already subject to the Tier 2 periodic reporting requirements, an issuer and participating broker-dealer are required to deliver the preliminary offering statement to prospective purchasers at least 48 hours in advance of sales.

Non-public review

An issuer may submit an offering statement for non-public review by the SEC. Consistent with the original Title I on-ramp provision available for EGCs, should an issuer opt for confidential review, the offering statement must be filed publicly not less than 21 calendar days before qualification of the offering statement. The timing, in the case of a Regulation A offering, is not tied to an issuer's road show, but rather to the qualification of the offering statement.

Form 1-A

An issuer that seeks to rely on Regulation A must file and qualify an offering statement. The offering statement is intended to be a disclosure document that provides potential investors with information that will form the basis of their investment decision. A notice of qualification is similar to a notice of effectiveness in an SEC-registered offering. Part I of the offering statement requires certain basic information regarding the issuer, its eligibility, the offering details, the jurisdictions where the securities will be offered, and sales of unregistered securities. Part II contains the narrative portion of the offering statement and requires: disclosures of basic information about the issuer; material risks; use of proceeds; an overview of the issuer's business; an MD&A type discussion; disclosures about executive officers and directors and compensation; beneficial ownership information; related party transactions; and a description of

the offered securities. This is similar to Part I of Form S-1, and an issuer can choose to comply with Part I of Form S-1 in connection with its offering statement. However, the disclosure requirements of Form 1-A are scaled.

Tier 1 and Tier 2 issuers must file balance sheets and other required financial statements as of the two most recently completed fiscal year-ends (or for such shorter time as they have been in existence). US issuers are required to prepare financial statements in accordance with US GAAP. Canadian issuers may use US GAAP or IFRS as adopted by the IASB. As with EGCs, an issuer may elect to delay implementation of new accounting standards to the extent such standards permit delayed implementation by non-public business entities. The election is a one-time election and must be disclosed. However, this election is not available to a reporting company issuer (including an EGC that did not elect delayed implementation in connection with its initial registration of securities) that is, at the time of the Regulation A offering, subject to the rules that apply to public business entities.

The financial statements for an issuer in a Tier 1 offering are not required to be audited. However, if a Tier 1 issuer already obtained an audit of its financial statement for other purposes and such audit was performed in accordance with US GAAS or the PCAOB standards, and the auditors meet the independence standards, then the audited financial statements must be filed.

The financial statements for an issuer in a Tier 2 offering are required to be audited. The audit firm must satisfy the independence standard but need not be PCAOB-registered. The financial statements may be audited in accordance with either US GAAS or PCAOB standards. An issuer in a Tier 2 offering that seeks to have a class of securities listed on a national securities exchange concurrent with the Regulation A offering must include financial statements prepared in accordance with PCAOB standards by a PCAOB-registered firm.

Continuous offerings

Rule 251 permits continuous or delayed offerings in certain instances, such as: securities offered or sold on behalf of selling security holders; securities offered under employee benefit plans; securities pledged as collateral; securities issued upon conversion of other outstanding securities or upon the exercise of options, warrants, or rights, etc.; and securities that are part of an offering that commences within two calendar days after the qualification date, will be offered on an continuous basis, may continue to be offered for a period in excess of 30 days from the date of initial qualification, and will be offered in an amount that, at the time the offering statement is qualified, is reasonably expected to be sold within a period of two years from the initial qualification date. The offerings permitted under Regulation A are limited in the same manner as under Rule 415 under the Securities Act; as such, delayed offerings would not be permitted under Regulation A.

Offering communications

An issuer engaged in a Regulation A offering has substantial flexibility regarding offering communications. An issuer must file solicitation materials with the SEC. Solicitation materials used after an offering statement is filed must be accompanied by the offering circular or include a link to the offering statement. Solicitation materials are subject to certain legends.

Ongoing reporting requirements

Rule 257 imposes ongoing reporting obligations for certain offerings. Tier 1 issuers are required to provide certain information about their Regulation A offerings on an exit report Form 1-Z not later than 30 days after the termination or completion of an offering. Issuers in Tier 2 offerings are subject to an ongoing reporting regime. Similar to the

ongoing reporting regime that the SEC adopted in connection with issuers that conduct crowdfunded offerings, Tier 2 issuers are required to file:

- annual reports on Form 1-K;
- semi-annual reports on Form 1-SA;
- current reports on Form 1-U;
- special financial reports on Form 1-K and Form 1-SA; and
- exit reports on Form 1-Z.

Form 1-K requires: disclosures relating to the issuer's business and operations for the preceding three fiscal years (or since inception if in existence for less than three years), related party transactions, beneficial ownership, executive officers and directors, and executive compensation; MD&A; and two years of audited financial statements. Form 1-K is required to be filed within 120 calendar days of the issuer's fiscal year-end. The semi-annual report on Form 1-SA is similar to a Form 10-Q, although it is subject to scaled disclosure requirements. Form 1-SA is required to be filed within 90 days of the end of the first six months of the issuer's fiscal year-end, commencing immediately following the most recent fiscal year for which full financial statements were included in the offering statement or, if the offering statement included six-month interim financial statements for the most recent full fiscal year, then for the first six months of the following fiscal year. A current report on Form 1-U is required to announce: fundamental changes in the issuer's business; entry into bankruptcy or receivership proceedings; material modifications to the rights of security holders; changes in accountants; non-reliance on audited financial statements; changes in control; changes in key executive officers; and sales of 10% or more of outstanding equity securities in exempt offerings. Form 1-U must be filed within four business days of the triggering event. An exit report on Form 1-Z is required to be filed within 30 days after the termination or completion of a Regulation A offering.

In January 2019, following the amendments to Rule 251, an issuer that is subject to the Exchange Act's reporting requirements is deemed

to satisfy Regulation A's reporting requirements so long as such issuer has filed all reports required by be filed by section 13 or 15(d) of the Exchange Act during the 12 months (or such shorter period that the registrant was required to file such reports) preceding.

Rule 15c2-11, Rule 144, and Rule 144A

A Tier 2 issuer's periodic reports will satisfy Exchange Act Rule 15c2-11 broker-dealer requirements relating to the obligation to review information about an issuer in connection with publishing quotations on any facility other than a national securities exchange. However, contrary to commenters' requests, Regulation A does not establish that these reports would constitute current information for purposes of Rule 144 and Rule 144A under the Securities Act. A Tier 2 issuer that voluntarily submits quarterly information in a form consistent with that required for semi-annual information would be able to satisfy the reasonably current information and adequate current public information requirements.

Tier 2 offering with concurrent Exchange Act registration

The final rules adopted by the SEC in 2015 allow a Tier 2 issuer to voluntarily register a class of Regulation A securities under the Exchange Act. In the absence of the relief provided in the final rules, an issuer that completed a Regulation A offering and sought to list a class of securities on a national securities exchange would have had to incur the costs and the timing delays associated with preparing and filing a separate registration statement on Form 10. The final rule permits a Tier 2 issuer that has provided disclosure in Part II of Form 1-A that follows Part 1 of Form S-1 (or for REITs, Form S-11) to file a Form 8-A to list its securities on a national securities exchange.

Of course, thereafter, the issuer would be subject to Exchange Act reporting requirements. An issuer that enters the Exchange Act reporting regime in this manner will be an EGC.

Termination or suspension of Tier 2 disclosure obligations

Tier 2 issuers are permitted to terminate or suspend their ongoing reporting obligations on a basis similar to the provisions for suspension or termination of reporting requirements for SEC-reporting companies. A Tier 2 issuer that has filed all required ongoing reports for the shorter of (1) the period since the issuer became subject to such reporting obligations or (2) its most recent three fiscal years and the portion of the current year preceding the date of filing Form 1-Z (termination or exit form) is permitted to suspend its reporting obligations at any time after completing reporting for the fiscal year in which the offering statement was qualified. This suspension is permitted if the securities of each class to which the offering statement relates are held of record by fewer than 300 persons and offers or sales made in reliance on a qualified offering statement are not ongoing.

Bad actor disqualification provisions

The final rule includes bad actor disqualification provisions that are largely consistent with those included in Rule 506(d) of Regulation D.

State securities law requirements

As discussed above, one of the most significant concerns regarding the use of the Regulation A exemption has been the requirement to comply with state securities or blue sky laws. At the time the new rules were proposed, there was no coordinated review process by the states for Regulation A offerings. Although NASAA has

introduced a coordinated review process for Regulation A offerings, the SEC noted that the coordinated review process is relatively new and it remains largely untested. Applicable SEC rules provide that Tier 1 offerings remain subject to state securities law requirements. On the other hand, Tier 2 offerings are not subject to state review if the securities are sold to qualified purchasers or, as provided by statute in the JOBS Act, listed on a national securities exchange. Rule 256 defines the term qualified purchaser in a Regulation A offering to include all offerees and purchasers in a Tier 2 offering. States will, of course, continue to have authority to require filing of offering materials and enforce anti-fraud provisions in connection with a Tier 2 offering.

Securities Act liability

Sellers of Regulation A securities have liability under section 12(a)(2) of the Securities Act in respect of offers or sales made by means of an offering statement or oral communications that include a material misleading statement or omission. While an exempt offering pursuant to Regulation A is excluded from the operation of section 11 of the Securities Act, those offerings are subject to the anti-fraud provisions under the federal securities laws such as Exchange Act Rule 10b-5.

Character of the securities sold in a Regulation A offering

The securities sold in a Regulation A offering are not considered restricted securities under Securities Act Rule 144. As a result, sales of the securities by persons who are not affiliates of the issuer are not be subject to any transfer restrictions under Rule 144. Affiliates, of course, continue to be subject to the limitations of Rule 144, other than the holding period requirement. However, the issuer's securities may not be listed or quoted on a national securities exchange without

registration under section 12 of the Exchange Act and, as a result, there may not be a liquid market for the securities or an applicable resale exemption.

FINRA review

For any public offering of securities, FINRA Rule 5110 prohibits FINRA members and their associated persons from participating in any manner unless they comply with the filing requirements of the rule.²² FINRA Rule 5110 also contains rules regarding underwriting compensation. Rule 5110(b) requires that certain documents and information be filed with and reviewed by FINRA, and these filing and review requirements apply to securities offered under Regulation A.²³ In September 2015, FINRA issued Notice to Members 15-32 providing guidance regarding the FINRA filing requirements and review process for Regulation A offerings. In practice, most Regulation A offerings have been completed without the use of a broker-dealer as an intermediary.

Considerations in conducting a Regulation A offering for a non-Exchange Act

Advantages

An exempt offering, including, for example, a Regulation D offering, is subject to several limitations, and a registered public offering may be too time-consuming and costly for an issuer. Using Regulation A to offer securities may provide an issuer with an offering format that is similar to a registered offering, but more efficient. While there are many similarities between an offering statement and a prospectus, the preparation of an offering statement is generally simpler, particularly for an issuer with a limited operating history. An offering statement is less

detailed than a prospectus for a registered offering. As a result, it is typically less costly for an issuer to conduct a Regulation A offering. The costs associated with external advisers, such as counsel and auditors, will also generally be lower in connection with a Regulation A offering. Also, management time devoted to the preparation of the offering statement will be minimized.²⁴ The review process undertaken by SEC staff may be somewhat shorter than the review and comment process in connection with a full registration. Timing is often the most important determinant of success for an offering. Inability to initiate an offering during a favourable market window may result in the issuer not being able to conduct an offering at all. Regulation A may provide flexibility to the issuer in this respect.

No limitation on offerees

Regulation A does not impose any limitations on offerees. In contrast to Rule 506 of Regulation D, Regulation A does not limit the number of offerees or investors that can participate in an offering, nor does it impose any requirement that offerees be accredited or sophisticated investors.

Nature of securities

Securities offered and sold pursuant to Regulation A are offered publicly and are not restricted securities. Assuming there is an applicable resale exemption, the securities may be traded in the secondary market (assuming that there is a secondary market) after the offering. As a practical matter, the securities are likely to trade in the over-the-counter (OTC) market unless the issuer has taken steps to list the class of securities on an exchange. No holding period applies to the holder of securities purchased in a Regulation A offering. Because an issuer may remain a non-reporting company after completion of a Regulation A offering, there may not be an active secondary market. If a smaller company chooses to list a class

of securities on a major exchange, it will become subject to Exchange Act reporting as well as to the governance requirements under the securities laws and under the rules of the exchange.²⁵ Certain institutional investors have limitations on the amount that they may invest in restricted securities. These restrictions generally would not apply to investments in securities issued pursuant to Regulation A; however, to date, most institutional investors have been wary of participating in Regulation A offerings.

Testing-the-waters, advertising, and general solicitation

The ability to test-the-waters in connection with a Regulation A offering may make a Regulation A offering more appealing than a Regulation D offering, even with the relaxation of the prohibition on general solicitation for offerings made pursuant to Rule 506(c).

Disadvantages

Dollar threshold

Although there are many significant benefits associated with a Regulation A offering, the \$50 million threshold undermines the benefits and reduces the utility of the exemption when compared to Rule 506.²⁶ Often, an issuer will look to engage an underwriter to assist with structuring and marketing the offering. Similar to a registered offering, the underwriting effort may be on a best-efforts or a firm commitment basis. The recent history of Regulation A shows that it is unlikely that a large well-established broker-dealer will underwrite a Regulation A offering. With the current offering threshold of \$50 million, participating in a Regulation A offering may not provide most broker-dealers with sufficient financial incentive.

Requirement of state registration

Offerings made pursuant to Tier 1 of Regulation A must satisfy blue sky laws in each state where the offering is to take place. An offering likely will trigger a merit review in those states that are merit review states (unless waivers can be obtained), which may cause delays in qualifying Regulation A offerings. By comparison, offerings of securities listed on major exchanges (Nasdaq and NYSE) have been exempt from state review since 1996 pursuant to the NSMIA. Similarly, securities offered pursuant to Rule 506 of Regulation D are exempt from state securities registration requirements.²⁷

Considering the alternatives

Many clients have asked us why an issuer might choose to rely on Regulation A if the issuer could rely on Rule 506 of Regulation D. An exempt offering, including, for example, a Regulation D offering, may still be subject to several limitations that may not be appealing to an issuer, and a registered public offering may still be too time-consuming and costly. Using Regulation A to offer securities can provide an issuer with an offering format that is similar to a registered offering. It might be especially appealing for an issuer to consider this type of offering as a precursor to an IPO. An issuer will be required to prepare and furnish certain offering disclosures in connection with a Regulation A offering, while there are no information requirements associated with a Rule 506 offering that is made to accredited investors. In practice, however, most issuers will prepare some disclosure materials to share with prospective investors, even in a Rule 506 offering that is made to accredited investors. An issuer may want to preserve the opportunity to approach investors that are not accredited investors, and may do so in connection with a Regulation A offering. To date, many consumer-facing issuers have found Regulation A offerings

appealing as affinity offerings that allow the issuers to reach their existing customer base.

A non-reporting company may choose to undertake a Regulation A offering or a Regulation D offering and remain below the shareholder threshold for required Exchange Act reporting. If it were to do so, a market for its securities may or may not develop. A non-reporting company that undertakes a Regulation A offering may also use the offering as an IPO.

Further guidance on Regulation A

Shortly following the effective date of the final rules, the SEC published a Small Entity Compliance Guide to provide market participants with an overview of the regulation. The staff of the SEC also published C&DIs on various aspects of the regulation. Among other things, these C&DIs noted that Regulation A could be applied in the context of merger transactions involving stock consideration. In July 2015, the SEC's Office of Investor Education and Advocacy issued an Investor Bulletin that highlights the differences from an investor's perspective between a Tier 1 and a Tier 2 offering, including the disclosure and ongoing reporting requirements and the investment limitation for Tier 2 offerings.

ENDNOTES

- 1 Securities Act Release No. 66, 1933 WL 28878 (Nov 1 1933).
- 2 Regulation A consists of Rules 251 through 263. 17 CFR section 230.251–.263, hereinafter cited by rule number.
- 3 See Pub. L. No. 96-477, section 301, 94 Stat. 2275, 2291 (1980).
- 4 See Small Business Initiatives, Securities Act Release No. 6949, 1992 WL 188930 (Jul 30 1992).
- 5 See Small Business Initiatives, Securities Act Release No. 6949, 1992 WL 188930 (Jul 30 1992).
- 6 See *id.* at *2.
- 7 See generally Rules 251–63. 17 CFR 230.251–.263.
- 8 See 2009 Annual SEC Government-Business Forum on Small Business Capital Formation 17 (2009).
- 9 See 29th Annual SEC Government-Business Forum on Small Business Capital Formation, Record of Proceedings (Nov 18 2010) (statement of David Hirschmann, President and CEO of the Center for Capital Markets Competitiveness at the US Chamber of Commerce).
- 10 See Statement of William R. Hambrecht, Chairman & Chief Exec. Officer, WR Hambrecht + Co.) ('According to public records, since 2005 there have only been 153 Reg A filings and of those 153, an astoundingly low number of 13 have actually priced.')
- 11 See A Proposal to Increase the Offering Limit Under SEC Regulation A: Hearing Before the H. Comm. on Fin. Servs., 111th Cong. 32 (2010) (prepared statement of William R. Hambrecht, Chairman & Chief Exec. Officer, WR Hambrecht + Co.)
- 12 See Small Company Capital Formation Act of 2011, HR 1070, 112th Cong. (1st Sess. 2011).
- 13 See press release issued by the House Financial Services Committee, available at <https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=247737>
- 14 Pub. L. No. 111-203, 124 Stat. 1376 (Jul 21 2010).
- 15 See generally Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty Before the Subcomm. on Capital Markets and Gov. Sponsored Enterprise of the H. Comm. on Fin. Servs., 112 Cong. 24 (2011).
- 16 Legislative Proposals to Promote Job Creation, Capital Formation, and Market Certainty Before the Subcomm. on Capital Markets and Gov. Sponsored Enterprise of the H. Comm. on Fin. Servs., 112 Cong. 24 (2011) (prepared statement of David Weild, Senior Advisor, Grant Thornton LLP).
- 17 Amendment to the Amendment in the Nature of a Substitute to HR 1070 Offered by Mr. Ackerman, no. 1a (emphasis added), available at <http://financialservices.house.gov/UploadedFiles/062211hr1070ackermanam.pdf>. As originally proposed, the legislation provided that the SEC may require an issuer to file audited financial statements with the SEC and distribute such statements to prospective investors.
- 18 National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3435 (Oct 11 1996). NSMIA pre-empts state qualification and registration requirements for covered securities, which includes issuer offerings of securities listed on Nasdaq or the NYSE and securities exempt from registration under federal securities law, including pursuant to rules promulgated under section 4(a)(2) of the Securities Act. Currently, there is no definition under the Securities Act of a qualified purchaser. The SEC would be required to adopt a definition.
- 19 See Letter from David S. Massey, North Carolina Deputy Securities Administrator, NASAA President, to Spencer H. Bachus, Chair., House Financial Services Committee, et al. (Jun 15 2011), available at www.nasaa.org/wp-content/uploads/2011/07/6-15-11-NASAA_Comment_Letter_HR1070_HR1082.pdf.

- 20 *See* study, available at www.gao.gov/assets/600/592113.pdf.
- 21 *See* letter from William F. Galvin, Secretary of the Commonwealth of Massachusetts, to the SEC (Dec 18 2013), available at www.sec.gov/comments/s7-11-13/s71113-1.pdf.
- 22 *See* FINRA Rule 5110.
- 23 *See* NASD Notice to Members 92-28 (May 1992); *see* also NASD Notice to Members 86-27 (Apr 1986).
- 24 The SEC has emphasized this advantage in the past. *See, e.g.*, Securities Act Release No. 5977, 1978 WL 196028, at *2 (Sep 11 1978).
- 25 An issuer may choose to prepare and file a Form 10 to register one or more classes of securities under section 12 of the Exchange Act with the SEC.
- 26 *See* A Proposal to Increase the Offering Limit Under SEC Regulation A: Hearing Before the H. Comm. on Fin. Servs., 111th Cong. 10 (2010) (statement of Michael Lempres, Asst. Gen. Counsel, SVB Financial Group) (“The impetus behind the creation of regulation A was very good one. Unfortunately, in recent years, as you’ve been hearing, regulation A has not proved to be a useful capital raising vehicle for small issuers. It was used only a total of 78 times during the 10-year period between 1995 and 2004. An average of eight filings a year with the maximum amount of \$5 million each really proves the irrelevance of regulation A in today’s economy. It’s simply not a viable vehicle as currently structured.”)
- 27 Rule 504 of Regulation D was promulgated under section 3(b) of the Securities Act and does not pre-empt state securities law requirements. However, most states have adopted changes to their state securities laws that essentially duplicate the provisions of Regulation D.

CHAPTER 7

Exchange Act registration thresholds

Before enactment of the JOBS Act, Exchange Act section 12(g) required registration of a class of an issuer's equity securities if, as of the last day of the issuer's fiscal year, the issuer had more than \$10 million in assets and a class of equity securities that was held of record by 500 or more persons.¹ Once these thresholds were crossed, an issuer would have to register the class of equity securities within 120 days of the end of the fiscal year, and then begin filing current and periodic reports with the SEC.² The definition of 'held of record' for these purposes counts as holders of record, only persons identified as owners on records of security holders maintained by the company, or on its behalf, in accordance with accepted practice. An issuer could only deregister a class of equity securities under section 12(g) when such class of equity securities was held of record by fewer than 300 persons, or by fewer than 500 persons and the total assets of the issuer had not exceeded \$10 million on the last day of each of the issuer's three most recent fiscal years. Exchange Act section 12(g) was originally enacted out of concern that issuers that did not have a class of equity securities listed on a national securities exchange could nonetheless have a class of stock that was widely held and traded over the counter, and therefore disclosure should be available to investors through SEC registration and reporting.

Leading up to the JOBS Act changes to the Exchange Act registration/deregistration thresholds, concerns were raised about the fact that the 500-person held-of-record threshold had not been revisited since 1964. These concerns focused on the fact that issuers sometimes

were compelled to go public sooner than they might have otherwise by virtue of the mandatory registration provisions in section 12(g), and the possibility of SEC registration and reporting could serve to discourage private companies from raising capital and using equity awards to compensate their employees. At the same time, concerns were expressed about issuers going dark and ceasing their SEC reporting by bringing the number of holders of record below the deregistration threshold. As a result of this dialogue, a variety of proposals were advanced relating to possible amendments to section 12(g) registration thresholds. Some of these proposals sought to reduce the number of issuers required to report pursuant to the Exchange Act, for example, by raising the shareholder threshold,³ by excluding employees, or by excluding accredited investors, QIBs or other sophisticated investors from the calculation.⁴ The SEC also received a rulemaking petition requesting that the SEC revise the held of record definition to look through record holders to the underlying beneficial owners of securities in order to prevent issuers from ceasing to report under certain circumstances.⁵ Before April 5 2012, the SEC was conducting a comprehensive study of these issues and was actively considering the various proposals.

Raising the registration and deregistration thresholds in Titles V and VI

As amended by Titles V and VI of the JOBS Act, Exchange Act section 12(g) now requires registration of a class of equity securities if, at the end of its fiscal year, an issuer has at least \$10 million in assets and a class of equity securities held of record by either 2,000 persons, or 500 persons who are not accredited investors. Banks⁶ and bank holding companies⁷ (BHCs) are not required to register under the Exchange Act unless they have, at the end of the fiscal year, at least \$10 million in assets and a class of equity securities

held of record by 2,000 or more persons. The FAST Act further amended Exchange Act section 12(g) so that savings and loan holding companies (SLHCs) are treated similarly to banks and BHCs. Under Exchange Act section 12(g)(4) before the enactment of the JOBS Act, an issuer could deregister a class of equity securities when either the issuer had \$10 million or less in assets and the class of equity securities was held by fewer than 500 holders of record, or the class of equity securities was held by fewer than 300 holders of record. The JOBS Act increased the 300 persons held-of-record threshold in Exchange Act section 12(g)(4) only with respect to banks and BHCs, raising that threshold from 300 to 1,200 persons. The JOBS Act did not increase the 300 persons held-of-record threshold for deregistration for issuers that are not banks or BHCs.

Under the JOBS Act, Exchange Act section 12(g)(5) was amended to provide that the term 'held of record' does not include securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act. The SEC was directed by the JOBS Act to amend the Rule 12g5-1 definition of held of record in order to reflect this amendment to the statute. The SEC was also directed to adopt safe harbor rules for issuers to follow in determining whether holders of their securities had received the securities pursuant to 'an employee compensation plan in transactions that were exempt from the registration requirements of section 5 of the Securities Act of 1933', and to provide that securities sold in exempt crowdfunding offerings will also not be included in determining whether registration is required under section 12(g).

On April 11 2012, the Division of Corporation Finance issued Frequently Asked Questions on Changes to the Requirements for Exchange Act Registration and Deregistration, which confirmed that the Title V and Title VI provisions raising the Exchange Act registration/deregistration thresholds were, for the most part, immediately effective, thereby

providing issuers with the ability to avoid registration in 2012 and going forward and, specifically with regard to BHCs, to terminate their registration/reporting obligation.⁸

In FAQ 4, the SEC noted that if a BHC with a class of equity securities held of record by fewer than 1,200 persons as of the first day of the current fiscal year has a registration statement that is updated during the current fiscal year pursuant to Securities Act section 10(a)(3), but under which no sales have been made during the current fiscal year, then the BHC may be eligible to seek no-action relief to suspend its section 15(d) reporting obligation. The staff has been granting these no-action letters.⁹

In FAQ 5, the SEC noted that an issuer (including a BHC) may exclude persons who received securities pursuant to an employee compensation plan in Securities Act–exempt transactions, whether or not the person is a current employee of the issuer. While section 503 of the JOBS Act directs the SEC to adopt safe harbor provisions that issuers can follow when determining whether holders of their securities received the securities pursuant to an employee compensation plan in transactions that were exempt from the registration requirements of section 5 of the Securities Act, in the SEC’s view the lack of a safe harbor does not affect the application of Exchange Act section 12(g)(5).

Required study

The SEC was required to examine its authority to enforce Rule 12g5-1 to determine if new enforcement tools are required to enforce the anti-evasion provision contained in (b)(3) of the rule, and to provide recommendations to Congress within 120 days of the enactment of the JOBS Act. On October 16 2012, the SEC staff published the results of this mandated study, concluding that the statutes, rules and procedures as currently formulated provide the Division of Enforcement with sufficient tools to investigate and bring a case for section 12(g) violations based on section 12g5-1(b)(3).¹⁰

Final rules

As mentioned above, section 503 of the JOBS Act required the SEC to revise the definition of held of record to exclude, from the section 12(g)(1) holder-of-record calculation, persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act.

In May 2016, the SEC adopted final rules¹¹ pursuant to the JOBS Act, which, among other things, amended Exchange Rule 12g-1. As amended, an issuer is required, within 120 days after its fiscal year end, to register a class of equity securities pursuant to section 12(g)(1) if, on the last day of its most recent fiscal year:

- The issuer had total assets exceeding \$10 million.
- The class of equity securities was held of record by greater than (i) 2,000 persons or (ii) 500 persons who are not accredited investors, as defined under Rule 501(a), determined as of such date rather than at the time of the sale of the securities.
- In the case of a (i) bank, (ii) SLHC or (iii) BHC, the class of equity securities was held of record by greater than 2,000 persons.

The SEC further amended Rule 12g-1 to provide that the term accredited investor (for purposes of section 12(g)(1)) is defined within Rule 501(a) under the Securities Act as any person: (i) who comes within one or more of the categories of investors specifically listed in Rule 501(a); or (ii) whom the issuer reasonably believes comes within any such category. An issuer’s reasonable belief depends on the facts and circumstances surrounding the determination. Accordingly, under amended Rule 12g-1, an issuer will need to determine whether prior information provides a basis for a reasonable belief that the holder remains an accredited investor as of the last day of the fiscal year.

The final rules also amended the definition of held of record in Exchange Act Rule 12g5-1 to exclude certain securities held by persons who

received them pursuant to employee compensation plans; and established a non-exclusive safe harbor for issuers to assess whether holders of record received securities pursuant to an employee compensation plan in transactions exempt from the section 5 registration requirements.

For purposes of determining whether an issuer is required to register a class of equity securities pursuant to section 12(g)(1) of the Exchange Act, the issuer may exclude from the definition of held of record securities that are:

- held by persons who received the securities pursuant to an employee compensation plan in transactions exempt from, or not subject to, the section 5 registration requirements (now Rule 12g5-1(a)(8)(i)(A)); or
- held by persons who received the securities in a transaction exempt from, or not subject to, the section 5 registration requirements from the issuer, a predecessor of the issuer or an acquired company in substitution or exchange for excludable securities under Rule 12g5-1(a)(8)(i)(A), as long as the persons were eligible to receive securities pursuant to Rule 701(c) under the Securities Act at the time the excludable securities were originally issued (now Rule 12g5-1(a)(8)(i)(B)).

Pursuant to the safe harbor:

- An issuer may deem a person to have received securities pursuant to an employee compensation plan if the plan, and the person who received the securities pursuant to the plan, satisfies the plan and participant conditions of Rule 701(c).
- An issuer may, solely for purposes of section 12(g), deem the securities to have been issued in a transaction exempt from, or not subject to, the section 5 registration requirements if the issuer had a reasonable belief at the time of issuance that the securities were issued in such a transaction.

In its final rules, the SEC included restricted stock units in its rulemaking to satisfy the amendment to section 12(g)(5) of the Exchange Act to exclude from held-of-record securities held

by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5. Issuers may rely on the safe harbor to assess whether holders of record received securities pursuant to an employee compensation plan in transactions exempt from the section 5 registration requirements.

The final rules also amended Rule 12g-4(a) to provide that termination of registration under section 12(g) shall take effect in 90 days, or such shorter period as the SEC determines, after the issuer certifies on Form 15 that the class of securities is held of record by fewer than 300 persons (1,200 persons in the case of a bank, SLHC or BHC), or 500 persons where the total assets of the issuer have not exceeded \$10 million on the last day of each of the preceding three years. As a result of the changes to Rule 12g-4(a), banks, SHLCs and BHCs are able to terminate the registration of a class of securities and suspend immediately their duty to file current and periodic reports upon filing a certification on Form 15 at the 1,200-person threshold.

The table in Appendix A provides a summary of the Exchange Act registration/deregistration and reporting thresholds.

Companies remaining private longer

Whether or not intended, these changes brought about by the JOBS Act have made it easier for privately held companies to remain private longer. In recent years, many market participants and policymakers have sounded a cautionary note in pointing to the decline in the number of US public companies. According to a speech given by SEC Chairman Jay Clayton, the total number of listed companies in 1996 was about 8,100, compared to approximately 4,300 in 2016, or a nearly 50% decline in a decade. In a September 2019 speech, SEC Chairman Jay Clayton repeated his observation that growing companies are staying private substantially longer, and that we have

roughly half the number of public companies that we had 20 years ago.¹² On average, most issuers that do move forward with IPOs tend to be quite different from their predecessors. These companies have been in existence approximately nine to 11 years and have significantly higher market capitalisations at the time that they undertake their IPOs. Promising privately held companies have found that it may be more efficient to raise capital in successive private rounds of financing. Given the proliferation of investors, including private equity funds, hedge funds, family offices, sovereign

wealth funds, and crossover funds, willing and eager to invest in the securities of privately held companies, there has been relatively little impetus for companies to consider undertaking public offerings. The JOBS Act rules we discuss in this chapter certainly have allowed privately held companies to continue to conduct successive private capital raises without worrying about crossing the section 12(g) Exchange Act threshold.¹³ Of course, the decision to defer an IPO may be attributed to any number of other factors.

Appendix A SHAREHOLDER TRIGGERS

	Companies other than banks, BHCs and SLHCs	Banks, BHCs and SLHCs
Total assets at fiscal year-end that trigger reporting requirement if shareholder trigger is breached	\$10 million	\$10 million
Total number of holders of record that triggers reporting	2,000 holders of record OR 500 non-accredited investor holders of record	2,000 holders of record
Total number of holders of record to exit reporting	300 or fewer holders of record 500 or fewer holders of record if issuer's total assets have not exceeded \$10 million on the last day of each of the preceding three fiscal years	1,200 or fewer holders of record
Effectiveness	Immediately effective	For banks, BHCs and SLHCs, at the end of the issuer's first fiscal year following enactment of the JOBS Act

ENDNOTES

- 1 These thresholds were set forth in Exchange Act section 12(g)(1) and Exchange Act Rule 12g-1. When section 12(g) was enacted in 1964, the asset threshold was set at \$1 million. The asset threshold was most recently increased to \$10 million in 1996. SEC Release No. 34-37157 (May 1 1996), available at www.sec.gov/rules/final/34-37157.txt.
- 2 In addition, section 16 reporting and short-swing liability apply to insiders; beneficial ownership reporting applies to significant stockholders; the SEC's proxy rules apply to the issuer; and the various Sarbanes-Oxley and Dodd-Frank Act provisions apply as a result of Exchange Act section 12(g) registration.
- 3 *See, e.g.*, Comment Letter from American Bankers Association to SEC (Nov 12 2008), available at www.sec.gov/rules/petitions/4-483/4483-21.pdf.
- 4 *See, e.g.*, 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report (May 2010), available at www.sec.gov/info/smallbus/gbfor28.pdf.
- 5 Petition from Lawrence Goldstein to SEC (Feb 24 2009), available at www.sec.gov/rules/petitions/2009/petn4-483-add.pdf. *See also* Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities (Jul 3 2003), available at www.sec.gov/rules/petitions/petn4-483.htm.
- 6 Under Exchange Act section 12(i), banks do not register their securities or file reports with the SEC.
- 7 The term bank holding company is defined in the Bank Holding Company Act of 1956.
- 8 Frequently Asked Questions on Changes to the Requirements for Exchange Act Registration and Deregistration (Apr 11 2012), available at www.sec.gov/divisions/corpfin/guidance/cfjobsactfaq-12g.htm.
- 9 *See, e.g.*, Peoples Financial Services Corp. (Aug 16 2012); Central Virginia Bankshares, Inc. (Aug 8 2012); AB&T Financial Corporation (Jul 27 2012); Botetourt Bankshares, Inc. (Jul 24 2012); First Ottawa Bankshares (Jul 23 2012); Potomac Bancshares, Inc. (Jul 23 2012); Skagit State Bancorp, Inc. (Jul 20 2012); Touchmark Bancshares, Inc. (Jul 17 2012).
- 10 Report on Authority to Enforce Exchange Act Rule 12g5-1 and Subsection (b)(3) (Oct 15 2012), available at www.sec.gov/news/studies/2012/authority-to-enforce-rule-12g5-1.pdf.
- 11 SEC Release No. 33-10075 (May 3 2016), available at www.sec.gov/rules/final/2016/33-10075.pdf.
- 12 SEC Chairman Jay Clayton, Remarks at the Economic Club of New York (Sep 9 2019), available at www.sec.gov/news/speech/speech-clayton-2019-09-09.
- 13 The SEC, in its Jun 2019 Concept Release on Harmonization of Securities Offering Exemptions, also observed that the revised thresholds for registration under Section 12(g) of the Exchange Act brought about by the JOBS Act and the FAST Act, have enabled issuers to remain private longer than in the past. *See* SEC Release No. 33-10649 (Jun 18 2019), available at www.sec.gov/rules/concept/2019/33-10649.pdf at 13.

Epilogue

Expanding private capital markets and alternatives to the traditional IPO

The capital markets continue to experience dramatic changes even in the period since enactment of the JOBS Act. As discussed earlier, reliance on the private capital markets has become more and more significant in recent years, with ever greater amounts of capital raised in exempt transactions than in SEC-registered offerings. Despite the fact that the centerpiece of the JOBS Act was the IPO on-ramp provisions, which were intended to encourage more companies to pursue initial public offerings, the traditional IPO model continues to come under scrutiny. Venture capital investors and other institutional investors have challenged the need to rely on IPO underwriters to bring a company to market. Companies that do not need to raise capital in an IPO, but nonetheless would like to provide liquidity to existing stockholders through a listing of a class of their equity securities, are relying on direct listings. The securities exchanges also are exploring alternatives to the current direct listing approach that might allow for a direct listing and a concurrent offering. Private equity sponsors are turning to special purpose acquisition companies (SPACs) to raise capital in the public markets in order to undertake initial business combinations with private company targets. For a private company considering a potential IPO, merging into a SPAC has become another alternative approach to the public market.

In light of these changes, the SEC continues to assess the need to modernize the existing framework for exempt offerings, as well as the ways in which retail investors may participate in private offerings without sacrificing investor protections.

Below, we summarize a number of recent developments that will influence the capital markets for years to come.

Expanding private capital markets

As discussed below, the recent changes to the definition of accredited investor and QIB have the effect of broadening the types of investors that meet these standards. As the SEC moves forward to implement proposed amendments to the framework governing exempt offerings, it is reasonable to conclude that the amendments will facilitate capital formation through exempt offerings.

Concept release on harmonization of securities exemptions

In June 2019, the SEC released its Concept Release on Harmonization of Securities Offering Exemptions.¹ The Concept Release noted that the SEC's framework for exempt offerings developed over time and new exemptions had been introduced without an effort to harmonize the conditions or requirements for different exemptions. The Concept Release sought public comment on the ways in which the SEC would improve the exempt offering framework in order to promote capital formation. The Concept Release requested comment on the definition of 'accredited investor' in Rule 501(a) of Regulation D. Comment also was sought with respect to various aspects of Rule 506(b) and Rule 506(c), including whether, for example, the two safe harbors should be combined, whether additional

clarifications relating to the types of activities that constitute 'general solicitation' or 'general advertising' are needed, whether the requirement to undertake reasonable efforts to verify investor status have limited the utility of Rule 506(c), and whether non-accredited investors should be allowed to purchase securities in an exempt offering in which general solicitation is used. The Concept Release also considers whether changes are needed to several of the more recently adopted offering exemptions, including the exemptions for intrastate offerings, Regulation A, and Regulation Crowdfunding. The questions posed with respect to these exemptions relate to the offering thresholds, the information requirements, and other related issues. The Concept Release also solicits comment relating to the SEC's integration doctrine and the current integration safe harbors.

The Concept Release solicits comment from the public relating to the ways in which the SEC might promote greater participation by retail investors in private funds or private equity-like opportunities. SEC Chair Clayton has often commented publicly on the need to consider whether, given that more and more companies are remaining private longer, and private placement investment opportunities are available only to accredited or high net worth opportunities, retail investors are foreclosed from potentially attractive investment opportunities. Similarly, investments in private equity funds, venture capital funds, and hedge funds, all of which invest in the securities of private companies, are generally limited to high net worth investors. The Concept Release notes that retail investors might be offered opportunities to participate in offerings made by interval funds, tender offer funds, target date funds, and other SEC-registered funds. These funds are subject to SEC registration, and registered funds generally are subject to a comprehensive regulatory framework that would promote investor protection.

Finally, the Concept Release solicits public comment on the current resale exemptions and whether these should be modernized.

Proposed amendments to the exempt offering framework

In March 2020, following receipt of public comments in response to the Concept Release, the SEC released for comment proposed amendments to the exempt offering framework.² The proposed amendments set forth significant changes to the current SEC approach to integration of offerings conducted in close proximity to one another. The proposing release sets out a simplified approach consisting of four non-exclusive safe harbors. An offering that is made more than thirty days after the completion of another offering would not be integrated with the prior offering provided that for the subsequent exempt offering, investors were not solicited through a general solicitation and had a prior substantive relationship with the issuer. Carrying forward current integration safe harbors, offers and sales made in compliance with Rule 701 or in compliance with Regulation S would not be integrated with other offerings. A registered offering would not be integrated with a terminated or completed offering for which general solicitation is not permitted, a terminated or completed offering for which general solicitation is permitted and made only to QIBs and IAs, or an offering that was terminated or completed more than 30 days prior to the commencement of the registered offering. An offering involving general solicitation would not be integrated with another offering if it is made subsequent to any prior terminated or completed offering. The proposed amendments would also update Rule 152.

The SEC proposes exempting ‘demo days’ from the definition of general solicitation. In addition, in order to encourage greater reliance on Rule 506(c), the SEC proposes to expand the ways in which an issuer may verify investor status.

The proposals would also increase the offering thresholds for offerings made in compliance with Regulation A, Regulation Crowdfunding, and Rule 504, and harmonize the disclosure requirements for Regulation D offerings that are

made by private companies to non-accredited investors with the disclosures required under Regulation A.

Amendments to the definition of accredited investor

In August 2020, the SEC adopted amendments to the definition of accredited investor and related amendments to the definition of QIB.³ The amendments have the effect of broadening the categories of person and entity that qualify as accredited investors. The amendments add two new categories of accredited investors for natural persons, regardless of such person’s income or net worth. A natural person may qualify as an accredited investor, regardless of net income or net worth, if the person holds certain professional certifications, designations, or credentials that arise out of an examination administered by a self-regulatory organization or other industry body, which examination is intended to demonstrate comprehension and sophistication in the areas of securities and investing, and if information regarding holders of the certification, designation, or credential is publicly available. Initially, this category includes designations for licensed securities representatives (Series 7), licensed investment adviser representatives (Series 65), and licensed private securities offerings representatives (Series 82). A licensed person must be in ‘good standing’. The second added category allows knowledgeable employees to qualify as accredited investors for purposes of investing in the funds sponsored by their employers. For purposes of calculating income and net worth, as well as in the context of knowledgeable employee joint investments, an investor can aggregate the investor’s income or net worth, as the case may be, with that of a spousal equivalent.

The amendments add several new categories of entities to the accredited investor definition, including:

- SEC- and state-registered investment advisers;
- Rural business investment companies;

- Limited liability companies (or any similar business entity) that satisfy the other requirements of the definition of accredited investor (*i.e.*, total assets in excess of \$5 million and not formed for the specific purpose of acquiring the securities being offered);
- Any entity that does not otherwise qualify as an accredited investor owning investments in excess of \$5 million that is not formed for the specific purpose of acquiring the securities being offered; and
- Any family office with at least \$5 million in assets under management and its family clients.

The SEC also amended the definition of QIB in Rule 144A to avoid inconsistencies and include the entities that qualify as IAs when these entities meet the \$100 million in securities owned and invested threshold in Rule 144A.

Alternatives to the traditional IPO

Critics of the traditional IPO contend that companies seeking to undertake an IPO must subject themselves to some measure of ‘underpricing’. In the current US bookbuilding approach to a traditional IPO, the underwriters gather indications of interest from potential investors, and this process provides for price discovery. The IPO price to public in successful IPOs (those in which the stock trades up once trading commences) may appear lower than the market price; however, IPO investors also are being compensated for the risk they have taken. In addition, critics note that the fee paid by IPO issuers to underwriters, which tends to be 7% of the IPO proceeds, is excessive. Smaller and medium-sized issuers argue that an IPO may fail to result in a liquid secondary market for the securities of the issuer. For companies with limited equity research coverage, an IPO may not offer many benefits. These are just a few of the complaints that have been voiced by entrepreneurs and venture capital investors. Perhaps as a result of some of these concerns,

there has been growing interest in alternative approaches.

Direct listings

A private company considering going public may evaluate a direct listing. In a direct listing, under the current framework, a private company registers to list a class of its equity securities on a national securities exchange and registers the resale of its securities held by existing stockholders. The private company does not issue and sell its own securities in the offering. As a result, a direct listing will not provide a capital raising opportunity. However, for many successful private companies, raising capital may not be the principal reason to become a public company. In fact, as we have noted, private companies have been raising significant amounts of capital in private placements and no longer rely on IPOs as the sole or as the principal means of raising capital. A well-funded private company may nonetheless want to have a public market for its securities. The company may want to provide a liquidity opportunity for its investors, as well as its employees who hold options or other stock-based compensation instruments. The company may also believe that it would be helpful to have a class of securities listed on a national securities exchange to use as acquisition currency to complete stock purchases in the future.

In connection with a direct listing, the company will still need to prepare a registration statement that will require the same information that would be included in an IPO registration statement. The registration statement will undergo the typical review and comment process with the SEC. Rather than engaging underwriters, the company will generally engage financial advisers to assist it in conducting outreach to institutional investors to familiarize them with the company, in part to ensure that there will be a liquid trading market for the company’s securities after the listing. Given that there are no underwriters, the price discovery

process that accompanies book building does not exist. The price at which securities are sold following the listing will depend on market factors and will not be subject to stabilization since there are no underwriters. Also, given that there are no underwriters, there is no traditional lock-up agreement. The company will not necessarily be able to control sales of its securities by stockholders following the listing.

Each of the national securities exchanges has specific rules that set forth the listing requirements for a company pursuing a direct listing. These rules are the subject of proposed amendments that are still pending review and approval by the SEC. The amendments may, if approved, allow for companies to sell shares on their own behalf in connection with a direct listing.

A direct listing may not be appropriate for all companies. To date, the experience on direct listings has been limited.

SPACs and mergers of private companies into SPACs

The SPAC transaction structure has been in existence since the 1990s; however, it is only in recent years that SPAC IPOs have flourished. In 2019, there were 59 SPAC IPOs, which raised \$13.6 billion in IPO proceeds. In 2020, through to August 30 2020, there have been 81 SPAC IPOs, which have raised \$33.1 billion in proceeds. Over time, the SPAC structure has evolved to become more investor-friendly, and better-known private equity sponsors have sponsored SPACs. For a private equity sponsor, a SPAC provides a permanent capital vehicle. A private equity sponsor may raise capital from a broader range of investors in a SPAC IPO compared to a private equity fund, in which investors are usually limited to institutional and high net worth investors. A SPAC is a public shell company that has no operating business and is formed in order to acquire a private company in an initial business combination within a specified time period, usually 24 months. Often, in connection with the SPAC IPO, the sponsor will

identify the industry that it will focus on for the initial business combination.

In the IPO, a SPAC will offer units, usually common stock and warrants, each of which will be listed and traded on a national securities exchange. The SPAC sponsor generally will receive for nominal consideration founders' shares, representing approximately 20% of the SPAC's common stock, in connection with the IPO. The SPAC sponsor also will purchase a different class of warrants. The SPAC IPO proceeds will be held in an interest-bearing trust account to be deployed in connection with the initial business combination.

For a privately held company considering its liquidity opportunities, it has now become common to consider undertaking a business combination with a SPAC, as a result of which the private company will be the continuing public company at completion. Some private companies and their advisers believe that merging with a SPAC may result in a better valuation for the private company and may provide for greater certainty rather than pursuing a traditional IPO on a standalone basis. In connection with a SPAC initial business combination, often referred to as a de-SPACING transaction, the SPAC and the private company target negotiate the terms of the merger or acquisition, including the valuation. The combination requires the approval of the SPAC's shareholders through a special meeting. A SPAC shareholder has an opportunity either to redeem the common stock for the original purchase price plus interest, or to sell the common stock to the SPAC in a tender offer. A holder may redeem the common stock regardless of a vote for or against the merger, and hold the warrants even if the holder redeems the common stock. In connection with the shareholder vote, the SPAC will prepare either a proxy statement or a proxy/prospectus. This will include detailed information, including financial information, regarding the private company target, which is equivalent to the type of disclosure that would be required in connection with an IPO.

As a result, a private company target should take into account that it will be required to negotiate a business combination transaction while at the same time preparing SEC disclosures.

Generally, such a transaction will require three to six months. Following completion of the business combination, the private company target is the continuing company and will be subject to the corporate governance requirements applicable to a public company. However, as a former shell company, for a period of time following the business combination, the company and its stockholders will be subject to certain limitations relating to, among other things, the use of a shelf registration statement and the ability to engage in certain offering related communications.

The capital markets have continued to change and adapt, and periods of great disruption – including the financial crisis – have been a catalyst for action. We witnessed this with the JOBS Act, which followed the financial crisis. Undoubtedly, the economic dislocations brought about as a result of the coronavirus pandemic will lead to more change.

Endnotes

- 1 Concept Release on Harmonization of Securities Offering Exemptions, Release No. 33-10649, available at <https://www.sec.gov/rules/concept/2019/33-10649.pdf>.
- 2 Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Release No. 33-10763, available at <https://www.sec.gov/rules/proposed/2020/33-10763.pdf>.
- 3 Amending the “Accredited Investor” Definition, Release No. 33-10824, available at <https://www.sec.gov/rules/final/2020/33-10824.pdf>.